Introduction to Compliance

This section addresses a trust department's overall compliance with applicable law, standards of fiduciary conduct and internally established policies and procedures. The compliance component includes evaluating the sensitivity of management and the board of directors to potential conflicts of interest. It also includes reviewing policies and procedures as they may relate to specific transactions and accounts.

The compliance evaluation is based upon, but not limited to, the following evaluation factors:

- Compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary and securities laws, the Employee Retirement Income Security Act of 1974 (ERISA), prudent investor and prudent man acts, principal and income acts and probate codes;
- Compliance with the terms of governing instruments;
- The adequacy of overall policies and procedures governing compliance, considering the size, complexity and risk profile of the savings association's trust and asset management activities;
- The adequacy of policies and procedures addressing account administration, including discretionary distributions, acceptance and termination of accounts;
- The adequacy and effectiveness of policies, procedures, systems and controls to identify and control conflicts of interest, including the use of affiliated investment products for discretionary fiduciary accounts;
- The adequacy of securities trading policies and procedures relating to the allocation of brokerage business, the use of "soft dollars" and the monitoring of the trading practices of investment personnel; and
- The extent and permissibility of transactions with affiliated or related parties, including investments in companies in which directors, officers or employees of the savings association may have an interest.

Types of Accounts

Several types of trust and asset management accounts are described in the narrative sections attached to specific examination programs in this manual. Those not described elsewhere are set forth below.

Charitable Trusts

A charitable trust may be established by will or agreement and is normally exempt from federal income tax if it meets Internal Revenue Code requirements. In many states, the attorney general enforces the rights of the charitable beneficiary. Charitable trusts may be established for many purposes but tax avoidance or tax reduction will normally be a significant consideration. The several types of charitable trusts can be distinguished by their features and may be segregated into the following:

- ***Charitable Lead Trust***: The charitable lead trust is an irrevocable trust that may be testamentary or inter-vivos (between living persons). Its primary provision is that income from the trust's assets goes to a named charity for a specified number of years. Upon termination of the trust, the principal is distributed to the designated (noncharitable) remaindermen.

- ***Charitable Remainder Unitrust (CRUT)***: The charitable remainder unitrust basically reverses the roles in the charitable lead trust. In the CRUT, the income beneficiary is a noncharitable person or entity but at termination, the principal of the trust goes to a charitable remainderman. The amount of income paid to the income beneficiary is based on a fixed percentage of the annually adjusted market value of the trust as of the beginning of the trust's tax year.
- ***Charitable Remainder Annuity Trust (CRAT)***: The charitable remainder annuity trust is similar to the CRUT, except that the annual amount paid to the noncharitable income beneficiary is a fixed amount based on the market value of the trust at funding.
- ***Foundations***: A foundation is a tax-exempt entity created by an individual, institution or organization for the benefit of educational or other public purposes relating to the arts, health and the sciences. Foundations are created to support the goals and objectives of specific institutions or causes but allow for income and estate tax relief for the founders. Trustee responsibilities may range from functioning as a limited agent to full discretionary trust management. These entities are subject to strict operating and disbursement guidelines established in the Internal Revenue Code.

Personal Agencies (aka Investment Management Accounts)

An agency relationship is established by an agreement under which the trust department is appointed agent for property belonging to the property owner (commonly referred to as the principal). The principal holds legal title and retains a legally enforceable right to control the disposition of the property. Duties of the trust department in an agency relationship commonly include accepting possession of the principal's assets, collecting and distributing income and buying and selling investments, either in the trust department's discretion (managed account) or as directed by the principal (self-directed account). When a savings association provides investment advice to, or is granted power by, the principal to manage the investments of the account, it is often referred to as an investment management agency account and is considered a fiduciary relationship. The same fiduciary standards apply to investment management agency accounts as to accounts where the savings association is trustee.

There are important distinctions between an agency and a trust relationship. Because an agency relationship is contractual in nature, either party may terminate it at any time. Another distinction is that a trustee holds legal title to the account assets while an agent does not. An agency is also revocable at the option of the principal and is revoked by the death of either party, while a trust may be irrevocable and continue beyond the death of a grantor or beneficiary. Finally, it is important to note that OTS regulations at 12 CFR §550 et al. do not apply to agency accounts unless the savings association has investment discretion or is providing investment advice, in other words unless it is a fiduciary relationship.

The acceptance of an agency account involves the same considerations as those for personal trust accounts. The agent's authority and responsibilities are limited to those expressly granted by the terms of the agreement and those that may be inferred as necessary to achieve the goals or objectives of the account.

Custody and Safekeeping Accounts

In a custody account the main responsibilities of the custodian (agent) are to preserve the property and to perform ministerial acts with respect to the property as directed by the principal. The agent has no investment or managerial responsibilities. In a safekeeping account the duties of the agent are to receive, safekeep and deliver the property in the account in accordance with the instructions of the principal. These are not fiduciary accounts and the standard of care that the savings association owes to these accounts is contractual rather than fiduciary in nature.

Escrow Accounts

In these accounts, a savings association has the responsibility of holding the assets and other documents delivered into its custody by the owner of the property (principal) until the conditions for the release to a third party have been fulfilled in accordance with the terms of the escrow agreement. In addition to its custodial duties, the savings association is responsible for ensuring that the conditions specified by the principal in the escrow agreement have been fully met in the manner intended before the assets and other documents are delivered to the third party. This makes the savings association liable for its actions not only to the principal but also to the third party. Care should be taken to determine that the savings association assumes no undue liability under the terms of the agreement, that its duties and obligations are clearly set forth in the escrow agreement and that it is not placed in the position of arbitrator.

Irrevocable Life Insurance Trusts (ILIT)

ILITs are becoming more widely used in estate planning as a means to transfer wealth without having to pay estate taxes on the transfer. Normally, the value of insurance policies owned by a decedent is included in the decedent's estate for estate tax purposes. This is true even if the proceeds are paid to a designated beneficiary other than the decedent's estate. However, if an ILIT is used to hold the "incidents of ownership" of a life insurance policy, it will allow the proceeds of the policy to escape inclusion in the grantor's estate when he/she dies. "Incidents of ownership" include the ability to cash in the policy, take a loan on it or change the policy's beneficiary designation.

When an ILIT is designated as a "crummey trust," the trust is the owner of the life insurance policy but it receives cash payments from the grantor to pay the premiums on the policy. The beneficiaries of the trust have a specified period of time (usually 30 days) to withdraw those cash payments before the premiums are paid. If the beneficiaries do not withdraw their proportional shares of the contributed cash (which would defeat the trust's purpose if they did), the contribution made by the grantor is used to pay the life insurance premiums. The IRS has ruled that this arrangement represents a gift of present value interest by the grantor. Since it is a gift of present value, the grantor may contribute up to $10,000 ($20,000 if the grantor and the grantor's spouse join in the contribution) per year per beneficiary in premium payments and enjoy the gift tax exclusion. When the donor dies, the life insurance policy in the trust generally is excluded from the grantor's estate.

The trustee has a number of responsibilities relating to the administration of ILITs. Policies and procedures should establish standards for review of the life insurance contracts for continued suitability and condition of the insurance company. Some states have passed laws limiting the fiduciary responsibilities relating to administering ILITs and the savings association should be familiar with those requirements. Particular attention should be paid to the governing instrument itself since it may increase or decrease a trustee's liabilities in regards to the ILIT.

Referral Fees

The primary fiduciary duty of a savings association in handling trust accounts is that of undivided loyalty to its trust customers. The paying of referral fees could raise self-dealing or other conflict of interest issues.

An OTS opinion states that an institution may pay referral fees to persons and entities that refer trust business to the institution, subject to certain conditions.[1] One of those conditions, that the fee be reasonable under the circumstances, should be reviewed on a case-by-case basis. The opinion concluded, among other things, that

[1] OTS Chief Counsel Opinion P-98-14 (December 21, 1998) (Payment of Finders' Fees for Referral of Trust Business).

paying a referring party a percentage of all fees earned on an account over a specified period was reasonable, based on the facts and circumstances present in the referral fee program discussed in the opinion. While the specific terms were considered reasonable in that instance, other fee arrangements may also be reasonable. The OTS will not arbitrarily impose limitations on referral fee amounts or on the length of time they continue to be paid. The savings association should be aware, however, that it might threaten its own financial condition by paying excessive or ongoing referral fees.

Savings associations with an existing referral fee program should make a good faith effort to meet the disclosure and acknowledgement conditions established in Thrift Bulletin 76-1, dated September 5, 2000 with regard to existing trust account customers.[2] When applying existing referral fee programs to new trust account customers, including successor trustee appointments, and when establishing new referral fee programs, the savings association should comply with the provisions of the bulletin immediately.

A savings association paying referral fees for trust business should structure its referral fee arrangement to meet the following conditions:

- The referral fee should be reasonable under the circumstances but should not result in a trust customer paying any additional amounts for trust services.
- There should be a written referral agreement between the savings association and the person or entity making the referral. Such agreement should: 1) describe any activities that the referring party will engage in on behalf of the savings association or trust account and the compensation to be received by the referring party; 2) contain a statement that the referring party will perform solicitation activities and any supporting services rendered to the pertinent accounts in a manner consistent with the instructions of the savings association and the appropriate provisions of law; 3) contain a requirement that the referring party provide to the prospective customer a current copy of a written disclosure statement prepared by the savings association as described below. The savings association should maintain a copy of this agreement in its records.
- A written disclosure document should be prepared by the savings association and given to prospective customers by the referring party that contains: 1) the name of the referring party and the savings association; 2) the nature of the relationship, including any affiliation, between the referring party and the savings association; 3) a statement indicating that only the savings association will provide fiduciary services; 4) the extent of any support services the referring party will perform; [3] 5) the terms of the referral arrangement, including a description of the compensation paid or to be paid to the referring party; and 6) a statement indicating that the referral fee will not result in any increased charges to the customer.
- The savings association should obtain a dated acknowledgement of receipt of the written disclosure document signed by the trust account customer. The savings association should maintain this signed documentation in its records.
- Savings associations registered as investment advisers should comply with any restrictions placed upon the payment of referral fees in accordance with applicable Securities and Exchange Commission and/or state securities regulations.[4]

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[2] The term "trust account customer" is defined as those persons or entities under applicable state law that are entitled to receive trust account statements or for employee benefit accounts it is defined as the plan sponsor.
[3] Examples of permissible support services are detailed in OCC Interpretive Letter #607 (August 24, 1992).
[4] 17 C.F.R. §275.206(4)-3 (Cash payments for Client Solicitations) generally prohibits an investment adviser registered under the Investment Advisers Act from paying a cash fee, directly or indirectly, to a third party (a "solicitor") with respect to solicitation activities for the adviser unless the arrangement complies with a number of conditions. Savings

- For referral fee relationships involving employee benefit plans subject to ERISA, the savings association should obtain an opinion of counsel that the fee arrangement does not violate any provisions of ERISA.
- For referral fee relationships involving affiliates, the savings association should ensure that it complies with the restrictions on transactions with affiliates or subsidiaries.[5]

associations registered as an investment adviser in one or more states must review and comply with any state securities laws applicable to the payment of referral fees.

[5] Certain types of transactions with affiliates are subject to the restrictions set forth at 12 U.S.C.A. §1468 and the OTS's transactions with affiliates regulation at 12 C.F.R. §§563.41-42. Specifically, §563.42(a)(2) covers referral fee arrangements. This regulation requires, among other things, that such transactions are to be on terms and under circumstances that are substantially the same, or at least as favorable to the savings association or its subsidiary, as those prevailing at the time for comparable transactions with or involving nonaffiliated entities.

Introduction to Conflicts of Interest

A savings association providing trust and asset management services to fiduciary accounts may face a variety of conflict of interest situations. Conflicts of interest generally occur due to the inherent differences between the institution's own interests and the interests of its fiduciary customers. As a fiduciary, a savings association has two primary duties to its customers: loyalty and prudence. In accordance with its duty of loyalty, it must always place the interests of its fiduciary customers first. This requires making decisions concerning the investment and management of trust assets based exclusively on the best interests of the trust account. When acting in a fiduciary capacity it should not place itself in a position in which its interests (or those of its subsidiaries or affiliates) conflict with those of trust customers. For instance, if a savings association has investment discretion for a fiduciary account and decides to use its own products or services or those of its subsidiaries or affiliates, it faces a conflict of interest situation.

A savings association also has a duty of prudence with regard to the fiduciary accounts for which it has investment discretion. The common-law duty of prudence requires a fiduciary to exercise the reasonable care and skill a man of ordinary prudence would exercise in the investment of his own assets, taking into consideration the preservation of the estate and the amount and regularity of income to be derived. This is known as the “prudent man” rule. Under the “prudent man” rule, a fiduciary generally will look at the investment of account assets on an individual asset basis. In an increasing number of states, the prudent man rule has evolved into the “prudent investor” rule. The “prudent investor” rule emphasizes the importance of overall risk management and looks to the diversification of the entire portfolio of trust account investments, without arbitrarily excluding any individual asset.

OTS takes the position that a savings association may engage in an action on behalf of its fiduciary accounts that otherwise would be a conflict of interest if the action is authorized by applicable law (i.e., the governing trust instrument, applicable federal or state law or court order) or, absent any prohibition, if all the beneficiaries consent after full disclosure. Obtaining the consent of all the beneficiaries may be difficult if more than one class of remaindermen exist or if the beneficiaries are minors, unborn, or otherwise unable to give informed consent. Under applicable state law, the savings association may need to have a guardian ad litem appointed for minors, the unborn, or the incompetent and obtain an order from the appropriate court approving the transaction.

OTS does, however, acknowledge that some states have enacted virtual representation statutes that may allow, under certain circumstances, the current beneficiaries of a trust to bind future beneficiaries. If a savings association is attempting to gain consent of all the beneficiaries of a trust in order to approve a conflict of interest transaction under such a statute, it should first obtain a well-reasoned opinion of counsel. That opinion should address whether the state statute applies in these circumstances, as well as whether all the provisions of the statute have been met. In any case, the savings association must fully and completely disclose the details surrounding the conflict in order for consent of all the beneficiaries to overcome the conflict.

If a savings association pursues an investment for a trust account for which it has discretion that presents a conflict of interest, but which applicable law authorizes, the trustee has not necessarily complied with the duty of prudence with respect to that investment. Good risk management practices require the savings association to document its decision making process in determining that an investment meets the prudence requirements of the applicable state statute.

The grantor of a revocable trust can direct the fiduciary to conduct otherwise impermissible transactions, unless the activity is illegal. If a transaction presents a breach of the duty of loyalty or prudence, the grantor of a revocable trust may authorize the transaction after full disclosure of the pertinent details. In such cases, before commencing the transaction, the savings association should document that full disclosure has been made and that the grantor authorized the transaction.

Conflicts of Interest in Regards to Mutual Fund Investments

More and more savings associations are receiving financial compensation or incentives from mutual funds for various services rendered. The mutual fund may (directly or indirectly) pay compensation to a savings association, or its affiliates, for investment advisory or other services. It may also pay compensation tied to the amount the savings association has invested in the mutual fund. With regard to mutual funds that are sponsored or managed by the savings association (proprietary mutual funds), the institution may receive compensation for services rendered to the mutual funds as well as indirect financial benefits resulting from the increased volume of investments in the funds.

The decision by the savings association to invest discretionary fiduciary assets in proprietary mutual funds presents a conflict of interest due to the direct and indirect financial benefits it receives. Most states have enacted legislation allowing such investments, as well as investments in nonaffiliated mutual funds from which the savings association receives financial benefits. The state laws often address the fees that may be charged to the fiduciary account as a result of the mutual fund investment as well as the fees that may be received by the savings association. State laws may also address the type of disclosure that must be given to beneficiaries of the fiduciary account and may require consent from beneficiaries before such an investment may be made.

Even if state law does not address disclosure of the nature of the conflict or the benefits the savings association is receiving as a result of the transaction, good risk management practices dictate that such disclosure should be made. The institution should inform account beneficiaries of the nature of the conflict and the financial benefits it will receive as a result of the transaction before the transaction takes place.[1]

Savings associations should understand and follow all the state and federal laws governing the investment of fiduciary account assets in mutual funds.[2] They should have well-developed policies and procedures that address how the institution will comply with the requirements of the laws and should develop a risk assessment process for monitoring compliance.

In documenting its determination that investment in a mutual fund from which the savings association is receiving compensation or incentives meets the state prudent man/prudent investor rules, the institution

[1] The term “affected account beneficiaries” is defined as those persons or entities under applicable state law that are entitled to receive trust account statements.

[2] If the savings association is acting as a trustee or other fiduciary for employee benefit accounts, it should be fully aware of all the ERISA restrictions regarding such conflict of interest transactions and meet any applicable Department of Labor (DOL) guidelines. The DOL has issued a prohibited transaction class exemption (PTE 77-4) that permits the investment of employee benefit accounts for which a savings association is a fiduciary in a proprietary mutual fund, provided certain conditions are met. The DOL has also issued several advisory opinion letters (93-12A and 93-13A) that address secondary services provided by a bank to a proprietary mutual fund without a waiver or credit of fees. The DOL has issued several advisory opinion letters on the subject of financial institutions providing services to employee benefit plans that are invested in mutual funds where those mutual funds are paying the financial institutions financial benefits as a result of the employee benefit plan investment. See Advisory Opinion 97-15A and Advisory Opinion 97-16A.

should describe the benefits derived by itself and the fiduciary account. It should include in its investment analysis such factors as historical investment performance and expense ratio comparisons in relation to similar mutual funds, ratings by services such as Morningstar, its familiarity with the mutual fund portfolio and investment manager, the generation of capital gains and losses within the fund, and any other relevant factors.

A savings association should also regularly document its decision to continue to retain specific mutual fund investments for fiduciary accounts. The documentation should include evidence that the investment continues to be appropriate for the individual account. This would include a discussion of the relevant prudence factors, any changes in the investment performance of the mutual fund, changes in fees or other costs charged by the mutual fund, changes in the trust account or the trust beneficiaries, and changes in the economy or overall market conditions.

The savings association may conduct this suitability review in conjunction with the annual review it must perform for all fiduciary accounts for which it has investment discretion. See 12 CFR §550.220.

Conflicts of Interest Examination Program

Examination Objectives

To determine management's effectiveness in identifying and monitoring conflicts of interest or self dealing in the trust department. Consider whether:

- the institution has adopted satisfactory policies and procedures to prevent or resolve self-dealing or other conflict of interest situations;
- effective systems and controls are in place to identify actual and potential conflicts of interest;
- policies and procedures and applicable law are followed when the savings association is faced with conflict of interest situations;
- the purchases, sales and holdings of the savings association's (and its subsidiaries or affiliates) own securities or other obligations are conducted in accordance with applicable law, provisions of the governing instrument and established policies and procedures;
- the purchases, sales and holdings of securities or other obligations of entities in which directors or principal officers of the savings institution or its affiliates have an interest are conducted in accordance with applicable law, provisions of the governing instrument and established policies and procedures;
- the purchases or holdings of deposits in the savings association or its affiliates are conducted in accordance with applicable law, provisions of the governing instrument and established policies and procedures;
- services provided by other departments of the savings association or its affiliates are proper and authorized;
- adequate practices are in effect to prohibit the use of material inside information by trust department personnel; and
- there is adequate documentation to support discretionary investment decisions.

Exam Date: ________________
Prepared By: ________________
Reviewed By: ________________
Docket #: ________________

Wkp. Ref.

Examination Procedures

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform particular Level II procedures.

1. Review examination scoping materials related to conflicts of interest. Scoping material should include:

   - Risk profile
   - PERK documents
   - ECEF reports
   - The most recent ADV filing and any amendments
   - Previous trust and asset management examination report
   - Previous safety and soundness examination report
   - Workpapers from the previous examination
   - Management's conflict of interest monitoring reports
   - Board and committee minutes

   ____ __________

2. Review policies and procedures regarding conflicts of interest for adequacy. Consider whether they address:

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

- Trust department employee code of ethics
- Prevention and use of material inside information
- Use of proprietary products and services
- The receipt of 12b-1 or other fees from proprietary or third party mutual funds
- Soft dollar arrangements and best execution
- Securities trading practices related to the allocation of brokerage business
- The extent and permissibility of transactions with related parties
- The disclosure of affiliated relationships
- Transactions between accounts

3. Evaluate the effectiveness of the trust department's internal systems to monitor compliance with its policies and procedures and to otherwise identify potential conflict of interest situations.

4. Determine whether any new trust or asset management products or services are being offered and whether they present any potential or actual conflicts of interest.

5. Review the trust department's information concerning entities in which the institution has a substantial interest. Ensure that this information is complete, accurate and available to the appropriate parties.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

6. Determine if the saving association's policies and procedures adequately address fee concessions to officers, directors and employees.

7. Consider whether the following risk contributors have been addressed:

   - The quality of written policies and procedures
   - The level and effectiveness of management oversight
   - The effectiveness of the audit, risk management and compliance programs
   - The ability and willingness to identify, monitor and address potential conflicts of interest
   - The nature of products and services offered
   - The use of affiliated products or services for which the savings association receives a fee or other benefit
   - The quality and effectiveness of educational programs for personnel

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. Review the list of assets held in discretionary accounts, paying particular attention to securities or other obligations of the savings association, its affiliates or related interests.

2. Review new or amended soft-dollar arrangements to determine whether they fall within the 28(e) safe harbor provisions.

3. Review the savings association's brokerage placement practices. Consider whether:

    - brokerage fees are monitored;
    - best execution is being achieved from designated brokers; and
    - trading opportunities are equitably allocated to all accounts.

4. If the trust department uses an affiliated broker to effect securities transactions for fiduciary accounts, determine that:

    - applicable law allows the use of an affiliate;
    - adequate disclosure is being made of the affiliated relationship; and
    - best execution is being achieved.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

5. Determine that uninvested trust funds are managed properly. Consider whether:

   - uninvested funds are awaiting investment or distribution;
   - funds remain uninvested no longer than is reasonably necessary;
   - funds held uninvested for more than a temporary period are held in accordance with applicable law; and
   - rate of return for uninvested funds is consistent with applicable law.

6. Determine that fees are charged in compliance with 12 CFR §550.380 or other applicable law. Consider whether:

   - fees are either set in accordance with applicable law or are reasonable given the nature of the services being provided;
   - revisions or changes in fees are appropriate and done in accordance with applicable law or policies and procedures; and
   - fee concessions for officers, directors and other employees are granted under a general policy that is uniformly applied and approved by the board.

7. Determine that the investment policies, procedures and practices require:

   - fair and equitable allocation of prices, securities and trading opportunities; and
   - buy and sell orders between fiduciary accounts to be conducted only where applicable law allows and on a fair and equitable basis.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

8. Determine that the savings association conducts educational programs for personnel to foster awareness of the importance of avoiding both the appearance of conflicts of interest and actual abuses.

9. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports; proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Review a sample of directed accounts holding savings association or affiliate securities. Determine if proper authorization for such investment exists. Also determine if the authorizations are updated periodically.

2. Review a sample of accounts holding proprietary products. Determine if the transactions involving those assets were conducted in accordance with applicable law and proper procedures. Determine if the assets meet the prudent law standard. Determine whether fees received from mutual funds are in accordance with applicable law.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

3. Review a sample of transactions involving cross-trading between fiduciary accounts and transactions between an account and the savings association or its affiliates. Determine if applicable law and proper procedures were followed.

4. Determine whether the trust department or an affiliate has been a member of a syndicate that sold debt securities or whether the trust department or an affiliate advised a party in a private placement or assisted in the placement. Using this list of syndicates or private placements, determine whether:

   - trust department personnel were notified of the participation in such securities activities; and
   - any such securities were purchased by a fiduciary account.

5. Determine whether the savings association, when acting as corporate bond trustee, performs an adequate check for conflicts of interest as required by the Trust Indenture Act of 1939.

6. Review conflict of interest situations involving corporate trust accounts under administration. Consider potential conflicts when corporate trust clients have borrowings with the commercial side of the savings association or have letters of credit from the commercial side supporting a bond issue.

7. Review proxies or lists of shares voted to determine whether the savings association has complied with its policies and procedures when voting its own stock and its holding company stock, particularly with respect to the election of directors. Determine that its policies require that it vote shares in the best interest of each account.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

8. Obtain a list of all companies or individuals to whom money is loaned by accounts in which the savings association exercises investment discretion. Determine whether the loan proceeds were used to pay any loan to the savings association.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 710P

Laws

Securities Exchange Act of 1934 — Section 28(e), Soft Dollars

Code of Federal Regulations

12 CFR 550	Trust Powers of Federal Associations (General)
12 CFR 550.140	Policies and Procedures
12 CFR 550.200-220	Annual Review of Trust Assets
12 CFR 550.290 – 320	Funds Awaiting Investment or Distribution
12 CFR 550.330 – 370	Restrictions on Self Dealing
12 CFR 550.380 – 400	Regulation Governing Gifts, Compensation, and Bequests

Office of Thrift Supervision Publications

TB 76-2 — Conflicts of Interest Relating to Fiduciary Accounts

Other

PTE 77-4	Investment of Qualified Plan Assets in Proprietary Mutual Funds
DOL Advisory Opinions	93-12A, 93-13A, 97-15, 97-16
12 CFR 270.12b-1(a)(2)	12b-1 Fees

Workpaper Attachments - 710P

Exam Date: ______
Prepared By: ______
Reviewed By: ______
Docket #: ______

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies

- Does the policy establish standards of business ethics?
- Does the policy define a conflict of interest?
- Does the policy set forth procedures for screening transactions to determine the existence of conflicts and provide a system of compliance?
- Does the policy address trust department employees serving as a cofiduciary?
- Does the policy address loans to fiduciary clients?
- Does the policy address trust department employees accepting gifts and bequests from fiduciary clients?
- Does the policy prevent employees from unauthorized trading?
- Does the policy prohibit personal trading based on information gained as an employee of the savings association?
- Are procedures in place for the reporting of personal securities transactions?
- Does the policy define material inside information?
- Does the policy suspend trading activity in affected securities until such information is made public?
- Are procedures in place to prohibit front running?

Own-bank Products and Services

- For own-institution deposits:
  - Is the investment allowable under local law and authorized by the governing instrument?
  - Are rates and services comparable to competing financial institutions?
- For proprietary mutual funds:
  - Is the investment allowable under applicable law?
  - Are appropriate disclosure procedures in place?
  - Has documentation been made that this is a prudent investment?
- For own-institution or affiliate securities:
  - Is the investment permitted under applicable law?
  - Has documentation been made that this is a prudent investment?
  - Are appropriate disclosure procedures in place?

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

• Are appropriate procedures in place governing the proxy voting of such securities?
• For affiliated brokerage, insurance or other services: • Does applicable law permit the use of these products and services? • Were proper disclosures made to the appropriate account holders?

Transactions With Accounts

Are policies and procedures in place governing:
• The sale of assets to itself from an account for which the savings association is a fiduciary?
• The making of a loan to an account that is secured by an interest in the assets of the account?
• The making of loans between fiduciary accounts?
• The sale of assets between fiduciary accounts?

Entities that savings associations may have an interest in

Information on entities in which the savings association has an interest should include:
• Names of directors and principal officers and their outside business affiliations.
• Names of affiliates, their directors and principal officers.
• Names of entities in which the savings association may have an interest, such as other financial institutions that have common directors or a degree of common ownership.
• Names of principal shareholders (5 percent and over) of the savings association and its affiliates, excluding directors and principal officers.
• The institution's large commercial customers.
• Names of other individuals with whom the savings association has a relationship that may affect the exercise of its best judgment, such as advisory or honorary directors and director's emeriti.
• Persons with whom the savings association conducts significant amounts of business, such as real estate brokers, agents and appraisers, securities brokers, legal and investment advisors, insurance agents and brokers and the companies with which such individuals are affiliated.
• Any syndication with which the savings association or an affiliate has engaged in the sale of securities or has advised or assisted in a private placement.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Introduction to Personal & Court Accounts

This section addresses a trust department's compliance with applicable laws and regulations, standards of fiduciary conduct and internally established policies and procedures relating to the administration of personal and court accounts. Policies and procedures should be evaluated in light of the size and character of the institution's trust and asset management business.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific duties, responsibilities and obligations. Risks associated with account administration may stem from failure to comply with applicable law and standards of fiduciary conduct, inadequate account administration practices, inexperienced management or inadequately trained staff.

Personal Trust Accounts

A trust is a fiduciary relationship by which legal title and the responsibility of ownership of assets is held by a person or corporation (the trustee) for the benefit of those holding an equitable interest in the assets (the beneficiaries).

Personal trust accounts can be broadly classified as **living** or **testamentary** and as either **revocable** or **irrevocable**. A living trust (also called an *inter vivos* trust or a trust under agreement) is created by voluntary agreement between a living person (grantor/settlor) and a trustee and becomes operative during the lifetime of the grantor. A testamentary trust (also called a trust under will) is created under the provisions of a person's (testator's) will and becomes operative only upon the death of the testator. A revocable trust is one in which the grantor reserves the right to terminate the trust at any time and have the trust property transferred back to his or her possession. In an irrevocable trust, the grantor cannot change any of the terms of the trust or revoke the trust. The benefit to the grantor of an irrevocable trust is that property placed within the trust moves out of the grantor's estate. It is the trust most commonly used for estate planning purposes.

Acceptance

A trust department is under neither a moral nor a legal obligation to accept all business that it is offered. 12 CFR §550.200 requires that prior to accepting a prospective fiduciary account, a trust department must determine whether it can properly administer the account. Trust departments should have written acceptance policies that are reviewed and approved by the board of directors or their designee. Among the specific factors to be considered when deciding whether to accept a trust are:

- whether the service can be provided at a profit to the department;
- the types of assets in the account;
- the legal sufficiency and administrative complexity of the account;
- whether any nonstandard duties are or will be imposed upon the trustee;
- whether any real or potential conflicts of interest exist; and

- whether the trust department has sufficient expertise to administer the account and appropriately invest the account's assets.

Criticism of acceptance policies should normally be limited to the absence of formalized policies or lack of emphasis placed on the preceding acceptance factors. Examiners should recognize that intangible factors might be involved in accepting an account. For example, an account may be accepted because of the customer's deposit relationship with the savings association. The extent to which these intangible factors should be criticized depends on the institution's ability to handle the accounts accepted under such circumstances and their overall effect on the department. These "special" accounts should be reviewed with an eye to: the number of such accounts; the profitability of the accounts; whether trust management has any voice in the acceptance process; available resources to administer the accounts; and the extent of the variation from stated acceptance policies.

Successor Trustee

A trust department may be asked or appointed to act as successor trustee in the event the original trustee is removed or is unable or unwilling to continue to act. Serving in this capacity may subject the institution to an additional source of liability stemming from the acts of the prior trustee. Therefore, a primary consideration prior to acceptance of such an account should be to ensure that appropriate steps are taken to avoid liability for actions of the prior trustee. Although a successor trustee is generally not liable for a breach of trust committed by a prior trustee, the successor may be liable if it knew or should have known of the breach and permitted it to continue, or if it neglects to take prompt action to compel the prior trustee to remedy breach. It is therefore essential that the trust department perform a due diligence review of all account activities prior to the time of its successor appointment. If the review discloses improper administration, the savings association should either: (1) refuse to accept the appointment, or (2) take immediate steps to protect the account beneficiaries by asserting liability against the prior trustee. The savings association may also request appropriate releases from liability from the court or from all beneficiaries to further protect itself from liability caused by the prior trustee. A written record should be maintained documenting the performance of a due diligence review and that appropriate measures were taken to protect both the account and the savings association against liability from actions of prior trustees.

Promptly upon acceptance, the board or its committee should determine the needs and objectives of the account and begin to structure the investments accordingly. In addition, under OTS regulation §550.210, if the savings association has investment discretion, it should conduct a prompt review of the assets held by the account and evaluate whether they are appropriate, both individually and collectively.

Conformity With Legal Requirements

The administration of personal trust accounts is primarily controlled by the terms of the governing instrument, generally a will, trust agreement or court order. State statutes and some federal laws control when the governing instrument is silent. There also exists a common law of trusts that has developed over time to help determine trustee responsibilities when neither statute nor the governing instrument address a particular issue.

Federal and state statutes and regulations govern the overall conduct of trustees (e.g., investment duties under the prudent investor or prudent man rule, the respective state version of the Uniform Principal and Income Act, the provisions of the HOLA and 12 CFR §550). They also govern the activities and the assets held that are incidental to trust and asset management activities (e.g., the federal securities laws govern securities activities, the Internal Revenue Code addresses taxation, consumer protection laws regulate lending

activities). Further, some of these laws and regulations are applicable to all trustees, while others, such as state financial codes, are applicable only to financial institutions acting as a trustee within that respective state. Applicable laws and regulations are discussed in further detail in Section 120 of this handbook**.**

The governing instrument will generally spell out the powers and duties of the trustee. In the absence of clearly defined provisions in the governing instrument, state statutes regarding the trustee's powers and duties would apply. A trustee's powers can be express or implied. Powers are express if they are granted by the instrument, court order or statute. They are implied if their exercise can be inferred as being necessary or appropriate to carry out the purpose of the trust. A trustee's powers can also be discretionary or nondiscretionary. A power is discretionary if the trustee is given authority to act without direction or approval from another party. It is nondiscretionary when another party has the authority to direct the trustee to perform certain acts. Among the more commonly granted trustee's powers are:

- Those pertaining to the retention, purchase and sale of assets;
- Those pertaining to distributions of principal and income cash;
- Those pertaining to the management of property, such as the power to lease real estate; and
- Those pertaining to the trustee's bookkeeping, accounting and safekeeping responsibilities. This may include the power to hold securities in nominee name, the power to vote securities by proxy and the power to deposit assets in an outside depository.

When two or more individuals or corporations participate in the administration of a trust or the settlement of an estate, they are known as cofiduciaries, cotrustees or coexecutors. It is not uncommon for the grantor or a family member to be appointed cotrustee with a savings association. Each trustee has a responsibility to participate in the administration of an account but ordinarily is liable only for its own actions. A corporate trustee is often held to a higher standard of care than an individual trustee. As a matter of sound policy and to protect itself against possible liability in a cotrustee situation, the savings association should maintain copies of all correspondence with cotrustees and obtain approvals from them for all discretionary actions.

Failure to comply with state and federal laws and regulations, common law or the terms of the governing instrument can result in financial losses to accounts and, in turn, to the savings association since it may be required to cover the losses. In addition, adverse publicity relating to the losses can damage the institution's reputation to the point that it may lead to a loss of business.

A will or trust instrument may include an exculpatory clause that attempts to relieve a trustee from certain liabilities. However, a trustee is not always protected by such a provision and it does not protect trustees from a breach of trust or actions that are illegal. In some states, courts have held that such provisions are void, thereby providing no protection for the savings association. Some states, however, have passed statutes affording limited protection to a trustee, such as protection to a successor trustee from acts of its predecessor(s).

Duties and Responsibilities

A trust department is subject to a number of duties and responsibilities arising as a result of its trustee relationship with its customers. In terms of account administration, one duty deserving of special mention is the responsibility to properly allocate receipts and expenses between principal and income in a personal trust account.

The provisions of the governing instrument for a personal trust often provide for the specific distribution of income and principal to two classes of beneficiaries. The two classes include income beneficiaries, who are to receive the income from the trust property and remainder beneficiaries, who are to receive the principal of the trust. During the account administration period, the trustee credits the receipt of income and debits the payment of expenses to the income or principal accounts of the trust. Receipts and expenses are to be allocated according to the terms of the governing instrument. If the governing instrument is silent, allocation is made in accordance with state statute. If state statute does not address the situation, allocations are made in accordance with case law. Finally, if there is no applicable case law, the trustee must determine what is reasonable and prudent.

In most states, the state's version of the Uniform, or Revised Uniform Principal and Income Act governs the trustee's duties regarding income and expense allocation. Generally, money received for the use of trust property or as a gain from the property is to be treated as trust income (e.g., ordinary receipts such as rents, dividends and interest). Substitutes for the trust property that amount to changes in form are to be considered trust principal (e.g., proceeds from the sale or exchange of assets). Special rules govern the allocation of some types of income, such as corporate distributions in the form of extraordinary dividends.

The most effective and commonly used method of insuring that the respective interests of income and remainder beneficiaries are kept separate is to maintain separate ledger accounts within the trust account for income and principal items. Except for standard accounting purposes, separate ledger accounts are not needed if no distinction is required for income and principal cash or where the income and principal beneficiaries are the same person. For example, agencies and estates generally do not require segregation of income and principal cash. Likewise, employee benefit accounts do not require a separate accounting for income and principal cash.

Termination

A personal trust closes at a specified time or upon the occurrence of a specified event. Typical closing triggers include: the trust's objectives being met, the death of the beneficiary (ies), the attainment of a specified date, the beneficiary(ies) reaching a specific age, or the exhaustion of trust principal. When these events occur, the trustee is responsible for terminating the account, distributing any remaining assets and preparing and filing required reports. In most states, a trust's duration is governed by the rule against perpetuities (21 years past the last beneficiary's death, plus 9 months). Some states, however, have recently repealed that rule, giving trusts in those states no legal ending date.

The governing instrument controls the form of asset distribution. Some require that all assets be liquidated and others require certain distributions of assets in kind. If the instrument is silent as to the form of distribution, the trustee is governed by state statute or the prudent exercise of discretion. The trustee is responsible for producing a schedule of distribution which includes information such as assets and their current fair market value, the method of distribution and each beneficiary's share of the assets and the trust's tax liability. State statutes may require filings with the court which would generate a release of the trustee from its obligations. Often, and particularly in the case of small, noncomplex trust accounts, the account may be closed with receipt and release agreements.

Court Accounts

There are two primary types of court accounts administered by a trust department, estates and guardianships. Estates consist of executor (named in a will and appointed by the court) and administrator (appointed by the court without a will) appointments for deceased individuals. Guardianships, which include conservator

appointments, are established for living persons. In an estate, the department is responsible for a decedent's assets from the time of death until a court approves the final settlement. In a guardianship, the trust department is responsible for conserving and managing the assets of a minor, a person suffering a legal disability such as incompetence or a person who is absent or unknown. The administration of estates and guardianships is supervised by a court (typically called a probate, surrogate or orphan's court) that reviews and approves all acts of the institution relating to the assets in the account. Court supervision is designed to protect the interests of deceased, minor, incompetent or unknown persons. The considerations involved in accepting court accounts are similar to those regarding personal trust accounts.

Estates

Although administration of an estate differs in many respects from the administration of a personal trust, the basic principle of sound fiduciary conduct applies to both and is demanded by the courts. Thus, the duties and responsibilities of a department acting as executor or administrator are governed by the provisions of the decedent's will, state probate codes, court order and sound fiduciary principles.

The trust department's primary duty and responsibility is to identify and protect all assets belonging to the estate. The department is also under a duty to collect obligations owed to the decedent and to pay obligations of the decedent. After proper notices have been published and claims filed, the department pays the claims in the order of their priority to the extent of assets available. The department may have to sell assets for the purpose of paying expenses or making requested cash distributions. An executor or administrator generally has full power to sell assets of the estate without obtaining court permission. The department is also required to render full and accurate accountings of its activities to the court. The format and time of the accounting are generally governed by state statute. Finally, the executor is responsible for filing and paying any federal and state income, estate and inheritance taxes.

The department's discretionary powers in estates are generally more limited than in trust accounts. For example, prior approval of the court is required for many transactions and the detailed accountings referred to above must be submitted to the court periodically. The department's investment responsibility is primarily to preserve the assets in anticipation of prompt distribution, not look to make them productive. However, if due to complexity or legal impediments the administration of an account is expected to last for several years, the department would be expected to make the estate's assets productive.

A final settlement should be filed as soon as the assets of the estate have been fully administered. Once the various tax returns have been filed, the taxes paid and appropriate closing letters received from the taxing authorities, the estate assets can usually be distributed and the account closed. The distribution is made to those persons or organizations designated in the will or under a controlling state statute. The department then files its final settlement and at the same time petitions the court to approve the final distribution of the assets. If acceptable, the court will then enter an order of discharge.

Guardianships

Under a guardianship arrangement, the ward (the person for which the guardianship was originally established) is the beneficial owner of the property and the trust department, acting as guardian, receives all powers and duties from the court. The duties of a guardian are similar to those of a trustee. Specifically, the guardian is obligated to:

- protect and preserve the assets;
- submit an inventory and appraisal to the court;

- retain or invest assets;
- use income and principal for the benefit of the ward; and
- submit an annual accounting to the court.

Investment limitations are often delineated by statute and any exceptions require court approval.

The guardianship terminates on the death of the ward, when a minor reaches legal age or when a court declares the ward competent.

Personal and Court Accounts Examination Program

Examination Objectives

To determine the adequacy and effectiveness of the trust department's administration of personal and court accounts. Consider whether:

- Effective policies, procedures and internal controls have been established;
- Expertise is available to administer the accounts;
- There is adequate documentation regarding administrative and investment decisions. The documentation should include all communication between the trust department, the beneficiaries and other interested parties;
- Policies and procedures have been established to ensure compliance with governing instruments, applicable law and accepted fiduciary principles; and
- Deficiencies are identified and corrective action promptly initiated.

Examination Procedures

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Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise to: determine if the trust department's practices conform to written guidelines; establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the administration of personal and court accounts. Scoping material should include:
    - Risk profile
    - Relevant PERK documents
    - Previous trust and asset management examination report

Exam Date: ________________
Prepared By: ________________
Reviewed By: ________________
Docket #: ________________

Wkp. Ref.

- Workpapers from the previous examination
- Examination reports of subordinate, functionally regulated entities
- Board of director and other applicable committee minutes
- Complaint and litigation files

2. Review the master list or account ledger(s) to determine account types and volumes being administered. Determine any changes in product offerings since the previous examination. Determine whether required approvals, notifications or registrations have been filed.

3. Review policies, procedures and internal controls related to the administration of personal and court accounts, noting any changes since the last examination. Determine the adequacy of policies and procedures, given the number and size of personal and court accounts, including:

- acceptance of accounts;
- administration of accounts (including cofiduciary and directed accounts); and
- termination of accounts.

4. Is there sufficient expertise to carry out administrative functions in accordance with existing policies and procedures? Identify and note any changes in personnel responsible for the administration of personal and court accounts.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

5. Consider whether the following risk contributors have been appropriately addressed:

   - Has the board implemented appropriate policies, procedures and internal controls covering all facets of account administration?
   - Have comprehensive and effective audit, compliance and risk management processes been established?
   - Does management exhibit the appropriate level of expertise to ensure compliance with applicable law and accepted fiduciary principles?
   - Are appropriate management reporting systems in place?
   - Does the trust department exhibit consistency in account administrative practices?
   - Are standards in place governing account documentation?

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. Review new business production (including both accepted and rejected accounts). Determine whether policies require that the trust department perform a preacceptance review of accounts prior to acceptance. Interview management to ensure the actual practice is consistent with stated policies.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

2. Interview management to determine whether account approval procedures are used, committee approvals are obtained, necessary documents are acquired and synoptic records are prepared consistent with policies and procedures.

3. Review successor appointment policies and procedures to determine whether acts of prior fiduciaries are reviewed, assets are properly received and appropriate documentation is obtained.

4. Review cofiduciary, directed and escrow account policies and procedures to determine whether necessary authorizations or directions are obtained and on file.

5. Review closed account policies and procedures to determine if there are established procedures for closing accounts and if reasons for closing are noted. Determine if the policies ensure that assets are transferred in a timely manner.

6. Review committee minutes to ensure that initial, annual and closing account reviews are adequately performed and documented in a timely manner consistent with internal policies and procedures and OTS regulations.

7. Review policies and procedures for estates to ensure that state probate laws are followed as appropriate. Also ensure that the policies address the timely filing of tax returns.

8. Are procedures in place to gain immediate physical control over the decedent's real and personal property? Are dual control procedures followed with respect to negotiable items, collectibles, safe deposit contents and other valuable property?

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

9. Are procedures in place to ensure that all items in the estate inventory are promptly recorded on the books of the account?

10. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of personal and court accounts for review. Ensure that the sample contains all types of accounts, including a selection of new, seasoned and closed accounts and provides coverage of all administrative personnel and all business locations. If necessary, select additional accounts considering:

   - accounts in which litigation is pending or has been threatened, and accounts for which complaints have been lodged with the institution;
   - accounts reviewed internally which exhibit identifiable concerns; and
   - accounts holding large investments in illiquid or unusual assets.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

2. From the sample, review account administration practices to determine compliance with terms of the governing instruments, applicable law, accepted fiduciary principles as well as conformance with policies and procedures.

3. Review accounts to determine that receipts and disbursements are received and processed appropriately.

4. Review accounts to determine conformance with policies and procedures relating to discretionary distributions.

5. Review accounts to determine that appropriate documentation is maintained supporting all account transactions. Determine accuracy of customer account statements.

6. Review accounts for conflicts of interest or preferential treatment to insiders or affiliates.

7. Review estates to determine whether any have remained in the process of settlement for an extended period of time, and if so, determine why.

8. Review discretionary account investments with regard to adherence to approved lists, diversification and the meeting of account objectives. Also review accounts with restricted investment clauses to determine compliance with the terms of the governing instruments.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

9. Review a selection of closed accounts to determine if the accounts were closed in accordance with established procedures and the assets transferred in a timely manner.

10. Review successor trusteeships to ensure that acts of prior fiduciaries are adequately reviewed and indemnification is obtained from the prior trustee or account beneficiaries.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 720P

Laws

HOLA	Section 5(n), Trusts

Code of Federal Regulations

12 CFR 550	Trust Powers (General)
12 CFR 550.200-220	Review of Fiduciary Accounts
12 CFR 550.410	Recordkeeping

Office of Thrift Supervision Publications

Other

Prudent Person Rule
Prudent Investor Rule

Workpaper Attachments - 720P

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Preacceptance Review

• Do policies and procedures identify documentation requirements for the preacceptance account review?
• Does the preacceptance process consider the type and character of account assets relative to administrative complexity and the institution's expertise?
• Does the preacceptance review consider provisions of the governing instrument, relative to legal sufficiency, administrative complexity and any unusual duties imposed?
• Does the preacceptance review consider whether the account can be administered to achieve the purpose for which it was established?
• Does the review identify any real or potential conflicts?
• Is the potential profitability of the account considered?
• Are environmental risks and other liabilities for assets such as real property and closely held business interests identified?

Account Approval

• Does the board of directors approve all new accounts?
• If the board of directors does not approve all new accounts, has there been proper delegation of acceptance authority to a committee or individual officers, with guidelines established for decision-making?
• Is there documentation of approvals in appropriate minutes, reports or files?
• Has the trust department obtained the appropriate executed account documents?

Successor Appointments

• Is proof obtained of the prior trustee's removal or resignation?
• Are original or certified copies of governing instruments obtained?
• Does the trust department verify that all governing documents and essential supporting documentation have been received?
• Do trust department personnel obtain and review accountings by prior trustee(s)?
• Is a reconciliation performed to ensure that all assets, as well as any income, have been received?
• Does the trust department obtain indemnification from the prior trustee or the account beneficiaries for activities of the prior trustee?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Closed Accounts

• Are proper account documents, such as death certificates, final accountings, court discharges, directions to terminate and trustee releases on file?
• Are there procedures requiring the timely distribution of assets?
• Are receipts obtained and maintained for the delivery of account assets?
• Are account closing reviews and termination approvals recorded in appropriate committee minutes?
• Are closed accounts promptly removed from the trust accounting system?

Account Reviews

• For new accounts, are procedures in place to ensure that an initial review is performed within 60 days of receipt of assets?
• Are procedures in place to ensure that annual account reviews are performed in a timely and orderly manner?
• Are annual reviews documented and reviewed by senior management and the board of directors (or their designated committee)?
• During the annual review, are investment objectives updated?

Account Administration

• Do procedures employ documentation checklists for opening and closing accounts?
• Do procedures ensure that proxies are voted solely in the best interests of account beneficiaries?
• Are tickler files maintained relating to the preparation and timely execution of future duties?
• Are adequate controls in place to ensure the timely recording of assets and liabilities received?
• Is evidence of appointment, such as trust or agency agreements, wills, letters of office from the court or similar documentation, maintained?
• Are proper and timely written authorizations from cofiduciaries or others whose approval or direction may be required for various actions, maintained?
• Do procedures ensure accuracy of income and principal allocation, as appropriate?
• Are timely filings of accountings with the court, principals, grantors, trustees or beneficiaries made?
• Are appropriate approvals by the board of directors or its designated committee obtained and documented?
• Do procedures require obtaining appropriate executed account documents?
• Are procedures and controls in place to identify and review tax filing requirements for accounts and is the tax information entered into the trust systems on a timely basis?
• Are closed accounts removed from the tax accounting system on a timely basis?
• Has the savings association established the proper amount of quarterly taxes due and are they being filed on a timely basis?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

• Are federal and state estate taxes paid within the time limits required by the Internal Revenue Code and state law?
• For estates, are fair market values of the estate assets obtained?
• Are the effects of the Generation Skipping Tax on distributions to younger generations being taken into consideration?
• Do policies and procedures address the handling of late taxes and the penalties and interest assessed to them?
• Does management review tax returns prepared by an outside service provider prior to actual filing?
• Are potentially escheatable assets properly identified and controlled?

Exam Date: ________________
Prepared By: ________________
Reviewed By: ________________
Docket #: ________________

Introduction to Employee Benefit Accounts

This section is intended to provide an overview of employee benefit plan administration, including the more important provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and those of the Internal Revenue Code (IRC). ERISA is a complex statute and many of its general rules have exceptions or rules of special application. Therefore, these materials should be considered as a general guide and not a definitive treatment of ERISA.

An employee benefit account administered by a trust department includes an employee benefit plan and a trust agreement created to administer the assets of the plan. The trust agreement may either be a part of the plan or a separate document. While there are a wide variety of employee benefit plans, only those commonly administered in a trust department are discussed in this section. These include defined benefit and defined contribution plans as well as individual retirement accounts (IRAs). Most qualified plans, which include all the plans discussed in this section with the exception of IRAs, are required under ERISA to hold the assets of the employee benefit plan in a trust.

Employee benefit plans as well as employee benefit trust administration are subject to a comprehensive scheme of federal law contained in ERISA, the Internal Revenue Code and the Pension Benefit Guarantee Corporation (PBGC). The U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) are the agencies responsible for regulations and interpretations issued pursuant to ERISA and the IRC. The PBGC insures the benefits of defined benefit plans to the extent provided in Title IV of ERISA.

ERISA consists of four major titles. Title I, “Protection of Employee Benefit Rights,” has “parts” relating to reporting and disclosure, participation and vesting, funding and fiduciary responsibility. Title II, contains the Internal Revenue Code provisions of ERISA. These are primarily interpreted by the IRS and are substantially similar to Title I in terms of fiduciary responsibility. Title III contains provisions establishing interagency jurisdiction and mandating coordination and exchanges of information between the responsible supervisory agencies. Title IV, “Plan Termination Insurance,” establishes the Pension Benefit Guaranty Corporation (PBGC), an insurance fund for defined benefit pension plans funded by premiums the plans are assessed on a yearly basis.

A trust and asset management examination of employee benefit accounts should focus on the prohibited transaction provisions of ERISA in Title I. ERISA §406, the primary section dealing with prohibited transactions, is divided into two parts. The first part prohibits fiduciaries of plans from causing the plan to engage in transactions with parties in interest. The second part sets forth additional prohibitions on transactions between a plan and a fiduciary of the plan. Certain transactions, otherwise prohibited, are exempted either by statute or by an administrative exemption granted by the DOL. A prohibited transaction violation usually generates a corresponding violation of the fiduciary responsibility provisions (exclusive benefit and/or prudence rules) of ERISA §404. Generally, the prohibited transaction violation is generally deemed to be the more concrete and significant of the two sets of violations. There is also a parallel set of violations involving §4975 of the IRC for most types of prohibited transactions. While IRC §4975 is similar to the provisions of ERISA regarding prohibited transactions, the two are not identical. If the prohibited transaction provisions of ERISA are violated, fiduciaries can be subject to substantial statutory penalties and surcharges. Therefore, it is especially important that a trust department have special expertise, policies and procedures in order to properly administer employee benefit accounts and IRAs.

All citations in this section are to ERISA unless otherwise noted.

Types of Benefits

The term "employee benefit plan," which is defined in ERISA §3(3), refers to employee pension benefit plans and employee welfare benefit plans. An employee pension benefit plan is any plan, fund or program that is established or maintained by an employer or employee organization that provides retirement income to employees. Employee pension benefit plans can be either "qualified" or "nonqualified." Qualified plans "qualify" for special tax treatment under the Internal Revenue Code. While many provisions of the IRC overlap provisions contained in ERISA, the IRC alone contains the tax qualification rules. Qualified plans, in turn, generally can be broken down into two categories: defined benefit plans and defined contribution plans. Nonqualified plans defer compensation or otherwise provide benefits payable at retirement or termination of employment but do not qualify for favorable tax treatment. Generally, nonqualified plans include executive or incentive compensation arrangements. Employee welfare benefit plans include plans that provide benefits such as medical, dental, life and disability insurance coverage. ERISA's trust requirements generally apply to welfare benefit plans. However, a welfare plan is exempt from ERISA's trust requirements if the assets of the plan consist solely of insurance contracts or policies.

Types of Qualified Employee Benefit Pension Plans

As mentioned above, qualified employee benefit pension plans may be classified into two primary categories: defined benefit plans and defined contribution plans. There are a wide variety of plans that fall under these broad categories. The one thing they have in common is that they must meet the strict standards set by the Internal Revenue Code in order to maintain their qualified status. For example, the IRC mandates that the plan document contain a number of requirements, such as provisions regarding nondiscrimination in eligibility for the plan and provisions to assure that executive and highly paid employees do not receive preferential treatment. Other requirements concern vesting, withdrawals, participant loans and distribution of benefits. IRC rules governing these matters are complex and are generally the concern of the plan sponsor, the plan administrator or the plan recordkeeper, however, many savings associations provide these services for plan sponsors and must perform them in compliance with various rules and regulations. Because tax laws and regulations are subject to frequent revisions, all products and services provided to plans must be constantly monitored to ensure that the tax-deductible status of the plan is maintained. Financial institutions providing products and services to employee benefit plans should have specialized expertise in this area.

A ***defined benefit pension plan*** guarantees a specific or determinable benefit to participants at normal retirement age and requires the sponsoring employer to contribute over a period of years whatever amounts are necessary to fund those benefits. For example, a defined benefit pension plan might provide a monthly benefit to each participant, payable at age 65, equal to $25 multiplied by the participant's number of years of service. In that example, a participant who had worked for 20 years would be entitled, at retirement, to a benefit equal to $500 per month for life. Because a defined benefit plan promises a certain benefit to an employee at his or her retirement, the employer is responsible for contributing to the plan the amount of funds necessary to pay benefits when they are due. In these plans an actuary is retained to determine what dollar level of contribution is necessary from the employer. If the investments perform better than the actuary has assumed or if salaries do not increase as expected, the actual amount of contributions necessary from the employer is reduced. Conversely, if the investments do not perform as well as the actuary assumes or if employee salaries increase faster than assumed, the employer must increase its contributions to make up the difference.

The Pension Benefit Guaranty Corporation (PBGC) insures defined benefit pension plans to the extent provided in Title IV of ERISA. If the employer becomes insolvent prior to contributing sufficient amounts to fund accrued benefits under the plan, the PBGC will step in and pay participants' pension benefits up to

certain levels. The plan sponsor pays premiums to the PBGC on a per participant per year basis for this coverage.

Defined benefit plans are more expensive to administer and operate than defined contribution plans. Due to the extra costs involved, defined benefit plans have fallen out of favor with plan sponsors and many have been terminated and replaced with defined contribution plans.

A ***cash balance plan*** is another form of defined benefit plan. It exhibits features of both defined benefit and defined contribution plans. The most recognizable feature of the cash balance plan is its use of a separate account for each participant, established upon the employee's becoming a member of the plan. The amounts an employer contributes to the plan are determined actuarially to ensure sufficient funds to provide for the benefits promised by the plan. The minimum funding standards apply to cash balance plans, as is the case with other types of defined benefit plans. Cash balance plans provide higher benefits for younger employees and lower benefits for older employees, in contrast to traditional defined benefit plans. This is because employer accruals under a typical cash balance plan remain relatively level, increasing only slightly toward the end of an employee's career. Employer accruals under a traditional defined benefit pension plan begin relatively low but increase sharply as an employee approaches retirement. This tends to make cash balance plans less costly to fund and operate than traditional defined benefit pension plans.

A ***defined contribution pension plan*** does not promise a specific benefit. Instead, the amount of an employee's benefit is based upon the amount contributed to the participant's account and the success of the plan's investment results. Each participant has an account under the plan and is entitled only to the amount in their account at retirement age. Contributions are made by the employer based on a formula established in the plan, such as a percentage of profits of the company, the salary of a participant or any number of other factors. Under some plans, the participant may also elect to make contributions to the plan out of his or her salary. This type of plan is not insured by the PBGC. Examples of these plans are: profit sharing plans, 401(k) plans, money purchase plans and target benefit plans.

A typical contribution formula under a ***profit sharing plan*** would provide that the employer would contribute to the plan each year an amount equal to a certain percentage of the company's profits and allocate the contribution, pro rata, according to the compensation paid to each participant for the year. Such plans are thought to foster productivity on the part of employees, as they will share in the profits of the company. Plan assets are often invested in employer securities. ERISA diversification requirements are not generally violated so long as the plan or trust instrument allows no more than 10 percent of the plan's assets to be invested in employer securities except as provided in ERISA §407(b). While these plans are called "profit sharing," there is no longer a requirement that the company has to make a profit to contribute to the plan. A profit sharing plan may provide benefits for employees, some or all of whom are owner-employees. Such a plan will be a qualified plan if it meets all the requirements contained in §§401(a) and 401(d) of the IRC. One of the §401(d) requirements is that contributions on behalf of owner-employees may be made only with respect to the earned income of the owner-employee that is derived from the trade or business with respect to which the plan is established.

A ***401(k) plan*** contains a cash or deferred arrangement (CODA). In these plans, an employee may make an election to have the employer make a contribution to the plan on the employee's behalf or pay an equivalent amount to the employee in cash. The amount contributed to the plan under the CODA on behalf of the employee is called an elective contribution. Subject to certain limitations, elective contributions are excluded from the employee's gross income for the year in which they are made and are not subject to taxation until distributed. Provisions contained in the Internal Revenue Code limit the total compensation contribution that a participant may make in any calendar year. The plan may provide for the employee to

make contributions as well, but again these contributions must comply with certain limitations established under the IRC.

State and local governments and tax-exempt organizations were prohibited until recently from maintaining 401(k) plans but certain plans, established before the law that prohibited them was enacted, were grandfathered. State or local governments with a plan established prior to May 6, 1986 or prior to July 2, 1986, in the case of tax-exempt organizations, were permitted to retain their 401(k) plans but not establish new ones. For years beginning after 1996, 401(k) plans, through a change in the tax law, were made available to tax-exempt organizations but remain unavailable to state and local governments, unless they have grandfathered plans.

In many of these plans, employees can choose to place their plan assets into several preselected investment vehicles. Many plans include employer stock as one of the investment options. Some plans that allow the employee to decide how to invest the funds in their plan account may operate in a way that reduces the fiduciary liability for both the sponsor and the trustee. However, in order to establish such a reduction in liability, the plan must be in full compliance with ERISA §404(c).

A ***money purchase pension plan*** (MPPP) requires the employer to contribute a specific percentage of eligible employees' compensation each year which would make age and length of service of the participant irrelevant for both contribution and allocation purposes. The obligation to fund the plan makes a money purchase pension plan different from most profit sharing plans. In most profit sharing plans, there are generally no unfavorable consequences for the company if it fails to make a contribution. However, if the company maintains a money purchase pension plan, its failure to make a contribution can result in the imposition of a penalty tax. Forfeitures that occur because of employee turnover may reduce future contributions of the company or may be used to increase the benefits of remaining participants.

Target benefit plans are individual account plans that are a hybrid of a money purchase plan and a defined benefit plan and are intended to provide a "targeted" benefit upon retirement. It is like a defined benefit plan in that the employer contributions to each participant account are established through a defined benefit formula calculated by an actuary. It is like a typical defined contribution plan in that there are no guarantees that the targeted benefit will be paid at retirement. If the earnings of the fund differ from those assumed, this does not result in any increase or decrease in employer contributions; instead, it increases or decreases the benefits payable to the participant. Thus, a target benefit plan operates much like a money purchase pension plan. The difference is that in a money purchase pension plan, contributions for identically compensated employees are the same even though their ages differ; in a target benefit plan, age is one of the factors that determines the size of the contributions. Because older employees have less time in which to have their benefits funded, employer contributions on their behalf are greater, as a percentage of compensation, than for younger employees. Consequently, target benefit plans appeal to employers that desire to benefit older employees.

Another type of qualified pension plan is an ***employee stock ownership plan (ESOP).*** An ESOP, although required to invest primarily in certain types of employer stock in accordance with IRC §409, is subject to most of the same Internal Revenue Code and ERISA requirements as other qualified defined contribution plans but there are some differences that subject a savings association that acts as a trustee for these plans to a greater degree of risk. The reasons for the increased risk are as follows:

- In addition to the Code requirements that apply to all qualified retirement plans, a series of special requirements apply to ESOPS under the IRC and ERISA.

- Anytime a trustee holds stock of the employer/plan sponsor, there is increased likelihood that the trustee will be drawn into a takeover battle in which the voting of shares held by the plan becomes an issue.
- An ESOP, by definition, is required to invest primarily in employer stock. This lack of diversification, though permitted under ERISA, exacerbates fiduciary liability issues in the event of a precipitous decline in the employer's stock price or the employer's insolvency.
- Where the ESOP holds stock of a private company or a sparsely traded public company, valuation issues frequently arise.
- Where the ESOP is leveraged, the existence of the stock purchase loan and the requirement of annual repayments can generate additional problems.

ESOPs are designed to invest "primarily" in "qualifying employer securities." Qualifying employer securities means publicly traded common stock of the employer. If the employer has no publicly traded common stock, the ESOP may invest in common stock with voting power and dividend rights that are equal to or greater than that of any class of the employer's common stock. The ESOP may invest in preferred stock under certain conditions. Employer securities that are not publicly traded, including preferred stock that is convertible into publicly traded common stock, must be valued by an independent appraiser upon purchase by the ESOP. The ESOP must value nonpublicly traded employer securities at least annually and upon special occurrences such as transactions with major shareholders. DOL regulations and case law have imposed a heavy burden on the fiduciary responsibility for determining the fair market value of the stock held by an ESOP. This burden includes the requirements of prudent investigation and strict independence from the employer. It is prudent for fiduciaries to rely on an independent appraiser to determine whether a purchase or sale of assets held by an ESOP is for adequate consideration.

A "leveraged" ESOP is an ESOP that borrows money from a bank or the employer and uses the proceeds of the loan to purchase employer stock. Often the employer will guarantee repayment of the loan. The ESOP holds the employer stock in a suspense account as the primary or sole asset of the ESOP. The employer is obligated to make annual contributions to the ESOP. The ESOP uses the annual employer contributions to make periodic principal and interest payments on the loan, pursuant to the loan agreement between the ESOP trustee and the lender. When the ESOP makes loan repayments, it allocates an equal portion of the employer stock from the suspense account to the accounts of ESOP participants. The IRC and ERISA permit qualified retirement plans other than ESOPs to borrow money. However, only ESOPs can borrow money using the credit or guarantees of the plan sponsor. To be exempt from the prohibited transaction provisions of ERISA, an ESOP loan must meet certain requirements that can be found at §408(e).

There are certain requirements that an ESOP must meet under IRC §409. The plan must allocate all employer securities transferred to it or purchased by it to the accounts of all the participants who are entitled to share in the allocation. Each participant is then given a nonforfeitable right to any of the employer securities that are allocated to his or her account. The plan may not distribute securities allocated to a participant's account before the end of the 84th month beginning after the month in which the security is allocated to the account unless certain specific conditions exist. Section 409(e) of the IRC contains requirements in regards to the proxy voting rights of the securities allocated to a participant's account. ESOPs, unlike other defined contribution plans, must pass through voting rights on allocated shares to the participants. The pass-through must be on all voting issues if the company is publicly held or if the ESOP acquired the allocated shares with the proceeds of a loan in connection with which the 50 percent interest exclusion was used. The pass-through is required only on important issues, such as a major corporate restructuring, if the company is not publicly held and the allocated shares are not affected by the 50 percent interest exclusion.

Welfare Benefit Plans

The most common types of employee welfare benefit plans are health, life insurance, disability, vacation and holiday, apprenticeship, educational or multiple employer welfare arrangements (MEWA) plans. Generally, ERISA §403(a) requires that all assets of an employee benefit plan be held in trust. This includes any assets of an employee welfare plan. However, ERISA's funding requirements are not applicable to welfare benefit plans and the IRC does not provide for tax-free accumulation to fund welfare benefit plans in the same manner as it does for pension plans. For this reason, most employers provide welfare benefits on a pay as you go basis rather than accumulating assets in a trust.

Rabbi Trusts

Some employers use a grantor trust (sometimes known as a "rabbi trust") to accumulate funds to pay employer-provided health benefits or to provide nonqualified deferred compensation benefits for management employees. The IRS has ruled that where the employer pays benefits from a rabbi trust, the employer can deduct its contributions for benefits and premiums in the year in which it pays such amounts to the recipient. This is also the year such amounts would have been taxable to the recipient but for the exclusions for employer-provided benefits. An employer ordinarily could not use a rabbi trust to satisfy ERISA's trust requirements because funds accumulated in a rabbi trust are treated as assets of the employer. Rabbi trust funds are subject to the claims of the employer's general creditors if the employer becomes insolvent or bankrupt. Both the DOL and the IRS have issued guidance with respect to rabbi trusts. For example, the DOL has issued an advisory opinion letter (94-31A, September 9, 1994) that indicates that an irrevocable grantor trust committed to pay retiree medical benefits are "plan assets" subject to ERISA's trust requirements. The Internal Revenue Service has issued guidance indicating that a rabbi trust holding stock in a parent company that is to be used to provide benefits for employees of a subsidiary company would generally not result in adverse tax consequences to the parent or the subsidiary but only if the trust assets are subject to the claims of creditors of both the parent company and the subsidiary (IRS Notice 2000-56).

VEBA

Examiners may also come across a voluntary employees' beneficiary association (VEBA). IRC §501(c)(9) establishes that a VEBA is a tax-exempt entity that is generally established by an employer or union to prefund health and other welfare benefits. Subject to significant limitations found in IRC §419, employer contributions to the VEBA are deductible by the employer and some funds accumulate tax-free.

Multiemployer Plans

Many companies maintain qualified retirement plans established under collective bargaining agreements. These plans are sometimes referred to as "Taft-Hartley" plans, so named in honor of the "Labor-Management Relations Act" (1947), which was sponsored by Sen. Robert A. Taft and Rep. Fred A. Hartley. Often a retirement plan negotiated by a union is set up on an industry-wide basis. These plans are very common in certain industries such as construction, transportation and mining. In multiemployer plans, two or more unrelated employers may participate in the plan under a collective bargaining agreement. There are separate requirements under ERISA that apply only to multiemployer plans. The main difference between these plans and other qualified plans is that a multiemployer plan is managed by a board of trustees composed of both union and employer representatives.

The PBGC has the authority to insure the benefits of a defined benefit multiemployer plan. This authority, which was established by federal courts, has been given despite the fact that a multiemployer plan usually combines the features of a defined benefit plan and a defined contribution plan.

Individual Retirement Accounts

An IRA is a tax-advantaged personal savings retirement plan that uses a trust or custodial account established in the United States. It can be used by employees and self-employed persons, even if they are covered by another plan, if all the conditions established in §408 of the Internal Revenue Code are met. The individual may also be able to deduct contributions to the IRA in whole or in part and the earnings and gains that accumulate within the IRA are not taxed until distributions commence. There are limitations on how much an individual may contribute to his or her IRA account. The limitation established at §408(a)(1) is $2,000 annually. (Note: The Economic Growth and Tax Relief Reconciliation Act of 2001 has increased this limitation, Pub. L. No. 107-16, June 7, 2001). The IRA account may not be invested in life insurance contracts as established by §408(a)(3) or collectibles such as stamps, coins, artwork, gems, antiques etc. (§408(m)) (An exception is made for U.S. American Eagle gold coins). Another basic characteristic of an IRA is that the individual's interest in the account must not be forfeitable. Finally, there are minimum distribution rules that must be followed to avoid any penalties for insufficient distributions. The distribution rules are similar to the distribution requirements of qualified plans.

The trustee (or custodian) of an IRA must be a bank, thrift, insurance company, brokerage firm or other person who demonstrates to the IRS that he or she will administer the account in a manner consistent with the requirements of the law. (See IRC §408(a)). The trustee of an IRA may contract to perform purely ministerial duties, such as calculating benefits, collecting and applying contributions, processing claims, preparing reports and tax forms or it may be charged with broad investment discretionary duties. Except in the case of a rollover contribution, described below, the trustee or custodian may not accept contributions to the IRC account unless it is in cash.

A savings association may act as a trustee or custodian of individual retirement accounts without obtaining trust powers from the OTS if it is permitted to do so under state law. However, under 12 CFR §550.580 - 620, there are certain conditions that a savings association must meet in regards to these IRA accounts. A savings association must observe principles of sound fiduciary administration as they relate to recordkeeping and segregation of assets. The savings association may either invest the assets of the IRA account in its deposits, obligations or securities or in any investment that the IRA customer chooses. Such self-directed IRA accounts are permitted to be serviced by savings associations without trust powers from the OTS if the institution does not exercise any investment discretion with regards to the IRA account assets or directly or indirectly provide any investment advice with regards to the accounts.

An IRA, even though the assets may be held within a trust, is not considered to be a "qualified" plan subject to the discrimination, vesting and other IRC §401 rules set out for qualified plans. IRA accounts are, however, subject to the prohibited transactions provisions of ERISA Section 406 and the parallel IRC §4975 provisions. IRAs are not subject to the fiduciary responsibility provisions of ERISA Section 404 covering prudence, diversification etc. There are certain prohibited transaction class exemptions that, provided all the conditions contained within the class exemption are met, allow IRA accounts to overcome violations of the prohibited transaction provisions. An example is PTE 91-55 that permits purchases and sales by IRAs of American Eagle bullion coins. Another example is PTE 93-33 that allows banks to provide IRA holders or their family members with services or products at either reduced cost or no cost. The services or product, such as free checking or a safety deposit box, must be the same as those offered by the bank in the ordinary course of its business to customers who do not maintain IRAs at the bank. In these cases, a prohibited transaction will not occur when an IRA holder, who is a fiduciary with respect to the IRA, uses IRA assets to obtain services from the bank. Under PTE 93-1, banks can offer cash or other premiums as incentives for opening IRAs or for making additional IRA contributions. The value of the premium on deposits up to $5,000 is limited to $10 and on deposits in excess of $5,000 is limited to $20.

A rollover IRA is a tax-free transfer of cash, securities, shares or other property from a qualified retirement plan (or an IRA) to another qualified retirement plan or to an individual retirement account. A rollover is generally paid directly to an eligible retirement plan (or IRA) from another retirement plan (or IRA) without the individual being involved at all. The means of transfer may be by wire transfer or by check made payable to the trustee of the accepting retirement plan. If a check is made out to the individual then, in most cases, a distribution has occurred not a rollover. There are no dollar limits on the amount that may be transferred in a rollover. Rollovers from one IRA account into another give IRA participants the flexibility to shift investments. To make the rollover tax-free, certain requirements must be met. The first requirement is that the amount distributed to the individual from the old account must be transferred to the new account not later than 60 days after receipt. The second is that, if property other than cash is received from the old account, that same property must be transferred to the new account.

Roth IRAs

In 1998, a new type of IRA was created, the Roth IRA. The major difference between a Roth IRA and the old type of IRA is that in a Roth IRA, contributions are not deductible but distributions may be income tax free. Another difference is that contributions to a Roth IRA may be made after an individual attains age 70 ½ and the minimum distribution rules do not apply during the individual's lifetime. An individual may also be eligible to roll over all or part of an IRA to a Roth IRA or convert an IRA into a Roth IRA. The Internal Revenue Code lays out all the provisions regarding Roth IRAs in §408A. The IRS has issued two model forms for use by financial institutions to offer Roth IRAs (Form 5305-RA and Form 5305-R).

Education IRAs

Along with Roth IRAs, in 1998, another type of IRA came into existence - the education IRA. An education IRA is a trust or custodial account created in the United States exclusively for the purpose of paying the qualified higher education expenses of an individual who is the trust's designated beneficiary. The account must be designated as an education IRA at the time it is created or organized. Although contributions to an education IRA are not deductible, distributions may be income tax free. The requirements of an education IRA are found in the Internal Revenue Code at §530.

Simplified Employee Pension Plans

A simplified employee pension plan (SEP) is an individual retirement account established for an employee to which the employer makes tax-deductible contributions. Certain IRC requirements (in §408(k)) must be met in order for these arrangements to work like qualified employee benefit plans but without the complexity and burden of many of the qualified plan rules.

Any employer, such as C and S corporations, partnerships and sole proprietorships may establish a SEP. To begin a SEP, the employer must execute a written instrument that includes the name of the employer, the participation requirements, the allocation formula and the signature of a responsible official. The SEP may use a model SEP (IRS Form 5305-SEP), a master or prototype plan for which a favorable opinion letter has been issued or an individually designed plan. All employees, including part-time employees, not excluded under one of the statutory exclusions in §408(k) must participate in the SEP. The SEP may not discriminate in favor of highly compensated employees. The assets of a SEP may be managed by a financial institution (any entity eligible to be an IRA custodian) although the employee may be permitted to direct the investment of his or her account. If the participant does not have an IRA, the employer must establish one for the participant. Employees, under a SEP are immediately vested in the assets of their IRA.

Savings Incentive Match Plans for Employees

A small business owner that wants to institute a retirement plan for his or her employees but does not want the complexity associated with a qualified plan may choose to institute a ***savings incentive match plan for employees*** (SIMPLE). A SIMPLE allows employees to make elective contributions and requires employers to make matching or nonelective contributions. The requirements for a SIMPLE can be found at §408(p). The SIMPLE may be structured as either a SIMPLE IRA plan or a SIMPLE 401(k) plan. SIMPLE plans are generally not subject to the nondiscrimination rules applicable to qualified retirement plans. Under a SIMPLE IRA, each employee may choose whether to have the employer make payments as contributions under the SIMPLE IRA plan or to receive these payments directly in cash. Contributions under a SIMPLE IRA may only be made to a SIMPLE IRA and not to any other type of IRA. Employers, including self-employed individuals, who employed 100 or fewer employees, may adopt a SIMPLE IRA. Each employee who received at least $5,000 in compensation from their employer during any two preceding calendar years and who is reasonably expected to receive at least $5,000 in compensation during the calendar year must be eligible to participate in the SIMPLE IRA plan for the calendar year. All contributions placed in the SIMPLE IRA are immediately vested. An employee may make elective contributions of up to $6,000 a year, adjusted for inflation, to a SIMPLE IRA (Note: these limitations have been increased by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, June 7, 2001). An employer must make either a matching contribution or a nonelective contribution. A dollar for dollar match of the employee's elective contribution of up to three percent of the employee's compensation for the entire calendar year is required or an employer may elect to make a nonelective contribution of two percent of compensation for each eligible employee regardless of whether the employee makes any elective contribution. Generally, an employer must permit an employee to select the financial institution for the SIMPLE IRA to which the employer will make all contributions on behalf of the employee. However, under certain conditions specified in §408(p)(7), an employer may require that all contributions on behalf of all eligible employees under the SIMPLE IRA plan be made to SIMPLE IRAs at a particular financial institution. A SIMPLE 401(k) is a 401(k) plan that meets the requirements established in IRC §401(k)(11) and all of the requirements of a qualified plan.

Master and Prototype Plans

*A **Master Plan*** is a form of a qualified plan established by a sponsoring organization, such as a bank or savings association. The plan is preapproved by the IRS and made available for adoption by employer/customers. Under a master plan, the sponsoring organization establishes a single funding medium (i.e. trust or custodial account) for joint use by all adopting employers. The plan consists of three parts: 1) a basic plan document, which is identical for all the employers that adopt the plan; 2) an adoption agreement, which generally contains options that an employer may select that relate to eligibility, vesting, contribution or benefit levels; and 3) a trust agreement under which all participating plan investments are held. Only a financial institution may establish and maintain a master plan. The financial institution, as the sponsoring organization, files the plan document form, the adoption agreement and the trust agreement with the IRS and asks for an opinion that the master plan is acceptable to the Service for a qualified plan and meets all the latest IRS 401(a) requirements.

A ***prototype plan*** is basically the same thing as a master plan except that the sponsoring organization establishes a separate funding medium for each adopting employer. Prototype plans are much more prevalent in the employee benefit world. In addition to financial institutions, law and accounting firms can sponsor a prototype plan.

A master or prototype plan may be either standardized or nonstandardized. A standardized plan is completely preapproved by the IRS. In these situations, an employer that adopts a standardized defined contribution plan and does not then or has never maintained another qualified plan covering any of the same participants, may rely on the sponsoring organization's IRS opinion letter and does not need a separate determination letter. A nonstandardized plan gives an adopting employer certain choices but very little flexibility as to plan design. The IRS preapproves nonstandardized plans but an adopting employer must apply for approval of its individual plan adoption with the IRS.

ERISA - Introduction

ERISA is a very complicated law and subject to constant change by way of legislation and by the issuance of various advisory opinions, prohibited transaction exemptions and regulations. The primary objective of ERISA is to protect the rights and interests of employee benefit plan participants and their beneficiaries. There are very specific standards in ERISA regarding how plans are to be administered and also regarding the investment of plan assets. There are also various reporting requirements to both the DOL and the IRS as well as disclosure requirements as they relate to the plan sponsor, plan participants and beneficiaries. Failure to properly follow the various rules and regulations issued by the DOL and the IRS may subject a savings association to civil money penalties for mismanagement. Before accepting any employee benefit account it is important that a savings association have special expertise and systems as well as adequate policies and procedures that are appropriate for the various types of employee benefit accounts.

Two governmental agencies are primarily responsible for the administration and enforcement of ERISA. The DOL is responsible for interpreting and enforcing the fiduciary provisions of ERISA. The IRS is responsible for the provisions found in Title II of ERISA and in the Internal Revenue Code under §401(a) that relate to maintaining the qualified status of a plan.

ERISA applies to all defined benefit and defined contribution plans which are sponsored by private entities. It will apply to most plans reviewed during examinations. ERISA does not apply to certain plans sponsored by federal, state and local government instrumentalities. These plans are generally known as "457" plans. ERISA also does not apply to plans sponsored by religious organizations and their affiliates, which are commonly known as "church" plans. Nonqualified plans, which are used to provide benefits to management and other highly compensated employees (and not the rank and file), are also exempt from most of the requirements of ERISA. The most common types of nonqualified plans are supplemental executive retirement plans (SERPs), Top Hat plans, rabbi trusts and secular trusts. One of the most significant disadvantages of a nonqualified plan is that, in order to avoid current taxation to the employee, the employer's obligation to pay benefits under the plan - including amounts attributable to employee compensation deferrals - must remain no more than an unfounded promise to pay amounts in the future. If a nonqualified plan were to be formally funded, the plan would become subject to, and in violation of ERISA and the participating employees would immediately recognize income on the nonqualified plan benefits. To remain unfounded for tax purposes, nonqualified plan benefits must be paid from the employer's general assets. However, most employers that maintain nonqualified plans have established an "informal" funding arrangement with respect to the plan.

ERISA Section 402 - Establishment of a Plan

Every employee benefit plan shall be established and maintained pursuant to a written instrument. The instrument must provide for one or more named fiduciaries that jointly or severally have authority to control and manage the operation and administration of the plan. Every employee benefit plan should:

- provide a procedure for establishing and carrying out a funding policy;
- describe any procedures for the allocation of responsibilities for the operation and administration of the plan;
- provide a procedure for amending the plan and for identifying the persons with authority to amend the plan; and
- specify the basis on which payments are made to and from the plan.

Examiners should note that the plan sponsor is generally responsible for ensuring that the plan meets the requirements of ERISA §402.

ERISA Section 403 - Trustee Requirements

ERISA §403 requires that one or more trustees must hold all assets of employee benefit plans in trust. There is no requirement that an institution or other corporate fiduciary be used, as individuals may serve as plan trustees under ERISA. An exception to this requirement is where the assets of the plan consist of insurance contracts or policies.

Trusteed plans are those most frequently encountered and a trust agreement, as distinguished from the governing plan, establishes the trustee's duties and responsibilities. The trustee, under ERISA, has the exclusive authority and discretion to manage and control the assets of the plan unless certain exceptions apply. One such exception is where the plan expressly provides that the trustee is subject to the direction of the named fiduciary as long as the directions are made in accordance with the terms of the plan and are not contrary to ERISA. Another exception is where the authority to manage, acquire or dispose of the assets of the plan is delegated to one or more investment manager(s).

Other typical trust agreement provisions relate to: irrevocability and nondiversion of trust assets; investment powers of the trustee; payment of legal and other fees; periodic reports by the trustee; records and accounts to be maintained; payment of benefits and the rights and duties of a trustee in case of amendments to or termination of the plan.

ERISA Section 404 - Fiduciary Responsibilities

ERISA's fiduciary provisions are intended to subject plan fiduciaries to a uniform federal fiduciary standard essentially based on common law principles. Under ERISA a fiduciary has five basic duties:

1. To act solely in the interests of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and to defray reasonable expenses of administering the plan (§404(a)(1)(A)). This duty is in essence a restatement of the common law requirement of fiduciary loyalty, which is sometimes referred to as the "duty of loyalty." In accordance with the duty of loyalty, a fiduciary is forbidden from acting in its own personal interest, or in the interest of a third party, or in any way contrary to the best interests of the plan and its participants. Examples of situations where a fiduciary was found to have violated ERISA's duty of loyalty include:

    - investing plan assets in a manner that indirectly favored the trustee;
    - churning a plan's assets so as to increase its fees;
    - making loans on favorable terms from plan assets to third persons;

- failing to attempt to collect on loans to itself; and
- permitting the diversion of plan assets to a union.

2. To act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" (§404(a)(1)(B)). This requirement contains the duty of prudence. Over the years the "prudent man" standard has evolved into a "prudent expert" standard. This is not to say that a fiduciary is required to be an expert in all facets (or in any) of the administration and management of a plan. However, it does mean that if the fiduciary is not an expert in any facet, it must seek the advice or retain the services, of one who is an expert. The DOL (29 C.F.R. 2550.404a-1), has stated that the requirements under this section will be met if the fiduciary has given appropriate consideration to those facts and circumstances that the fiduciary knows or should know are relevant to the particular investment. This basically means that the fiduciary must determine that the particular investment is reasonably designed to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain associated with the investment. The DOL in its regulations has also listed several factors that should be taken into consideration as they relate to the portfolio of the plan. The factors are: 1) the composition of the portfolio with regard to diversification; 2) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and 3) the projected return of the portfolio relative to the funding objectives of the plan.

   Courts have relied on a number of factors in order to determine whether an investment is prudent. Some factors are as follows: 1) the success of the investment (objective or comparison based); 2) expert testimony that the investment scheme was low risk; 3) the fiduciary is experienced and knowledgeable regarding the subject matter of the investment and has a proven track record; 4) the fiduciary thoroughly investigated the subject matter of the investment; 5) the fiduciary considered alternative investments; 6) the particular investment strategy was within industry standards; 7) the fiduciary provided a thorough and well-reasoned rationale for its actions; and 8) divestiture would cause a large loss to the plan.

3. To diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so (§404(a)(1)(C)).

4. To act in accordance with the documents and instruments governing the plan, insofar as they are consistent with the provisions of ERISA (§404(a)(1)(D)). Under this requirement, a fiduciary must not only be familiar and comply with the terms of the governing instrument but it must also determine whether any directives given by an authorized party are permissible under the overall fiduciary responsibility provisions of ERISA.

   An example of a fiduciary breach under this provision would be where a plan fiduciary invested in equity securities in amounts that exceeded limitations prescribed by the plan guidelines. The phrase "documents and other instruments governing the plan" generally would include any statements of investment policy or guidelines adopted by the plan sponsor, its investment committee or other named fiduciary.

5. To refrain from engaging in prohibited transactions (see ERISA Section 406 - Prohibited Transactions).

   In addition to the requirements found in §404(a), §404(b) requires that indica of ownership (security certificates, etc) of plan assets must be maintained within the jurisdiction of United States Courts. DOL Regulation 29 C.F.R. §2550.404(b)-1 lists some specific exceptions. Generally speaking, plans may invest in foreign property if they either bring the actual indicia of ownership (e.g. stock certificate, bond, property title or currency) back to the United States or arrange for such indicia of ownership to be maintained by certain entities that are subject to the jurisdiction of U.S. district courts.

Section 404(c)

ERISA §404(c) provides that if a participant in an individual account plan (typically a 401(k) plan) exercises control over the assets in his or her account, the participant will not be considered a plan fiduciary and trustees and other fiduciaries of the plan will be relieved from liability for any loss resulting from the participant's exercise of control, if all of the conditions stated in §404(c) are met. ERISA does not require that retirement plans and fiduciaries comply with the requirements of §404(c). Noncompliance only means that fiduciaries (trustee and plan sponsor) remain liable for damages resulting from participants' investment choices. There are extensive regulations contained at 29 C.F.R. §2550.404c-1 that gives guidance on how a plan can meet each of the three main components of §404(c). These components are as follows:

- Plan participants must have the opportunity to give investment instruction with a frequency appropriate to the market volatility of the investment alternatives. Plan participants must be able to make changes to at least three of the investment vehicles no less than once a quarter. If an investment vehicle permits investment changes more often than quarterly, the participant must have the ability to immediately roll the proceeds into another plan investment vehicle that is a low risk, liquid investment choice. Special provisions are given for investments in stock of the employer/sponsor.
- Plan participants must have the opportunity to exercise control by investing their accounts among a broad range of investment alternatives. At least three investment alternatives must be provided, each of which is diversified and has materially different risk and return characteristics. In practice, the three alternatives will generally consist of the following types of investment vehicles: (1) a "no-risk" investment [for example, money market mutual fund, or Guaranteed Investment contract (GIC)]; (2) a stock investment; and (3) a fixed-income investment. Employer stock may be a choice but special requirements apply to this investment.
- Plan participants must be given sufficient information to make informed investment decisions. This involves specific disclosures about the plan itself, as well as each authorized investment alternatives within the plan with respect to participants or beneficiaries of a plan.

When a plan sponsor, trustee or other fiduciary gives "investment advice" to plan participants, it will lose the protection gained through compliance with §404(c), and become exposed to fiduciary liability resulting from participants' investment decisions. The DOL has issued an interpretive bulletin (DOL Interp. Bull. 96-1) that provides guidance about what is "investment education" as opposed to "investment advice." The bulletin indicates generally that the primary difference between investment "education" and "advice" lies in how closely each addresses the individual participant's situation and makes specific recommendations. The bulletin provides four "safe harbor" categories of investment education information that may be given orally, in writing or over the internet.

ERISA Section 405 - Liability For Breach of Cofiduciary

In addition to any liability that a fiduciary may have for its own acts, a fiduciary may be held liable for a breach of duty committed by another fiduciary:

- If the fiduciary knowingly participates in or undertakes to conceal a breach by another fiduciary [§405(a)(1)];
- If the fiduciary enables another fiduciary to commit a breach by his failure to discharge his responsibilities prudently [§405(a)(2)]; or
- If the fiduciary has knowledge of a breach and fails to make reasonable efforts to remedy it [§405(a)(3)].

Fiduciaries that have limited functions do not insulate themselves from breaches by other fiduciaries. Failure to adequately monitor the conduct of another fiduciary may be deemed imprudent and cause cofiduciary liability. Resignation by the fiduciary as a protest against the breach is not sufficient to eliminate the liability; action must be taken to remedy the breach.

ERISA allows for allocation of specific responsibilities, obligations or duties among trustees and other fiduciaries in §405(b) and (c). The allocation of responsibilities requires specific authorization in the plan document. If the trust is one where a fiduciary is subject to the directions of an investment manager, the fiduciary will not be responsible for the investment manager's acts or omission; if, the investment manager is properly appointed in accordance with provisions of the plan, is a "qualified" investment manager and acknowledges its fiduciary status in writing. The trustee should insist that all "directions" be in writing or in a format other than oral.

Some plans include provisions authorizing each plan participant, at his or her election, to direct the investment of funds allocated to their account. In these cases, §404(c) affords protection to plan fiduciaries, including the trustee, if all the conditions set forth in DOL regulation 2550.404c-1 are met.

ERISA Section 406 - Prohibited Transactions

ERISA §406, the primary section dealing with prohibited transactions, is divided into two parts. The first part prohibits fiduciaries of plans from causing the plan to engage in transactions with parties in interest. The second part sets forth additional prohibitions on transactions between a plan and a fiduciary of the plan.

ERISA provides that a trustee or other fiduciary that causes a plan to engage in a prohibited transaction with a party in interest is personally liable for any loss the plan suffers from a violation and it must disgorge any profits earned as a result of the violation. The DOL also may impose a 20 percent excise tax on any amount received from a fiduciary because of its violation of the prohibited transaction rules. Finally, ERISA empowers courts to grant injunctive relief to stop prohibited transactions from going forward and imposes criminal penalties for willful violations. The IRC imposes a two-tiered penalty tax structure on parties in interest. Any party in interest who participates in a prohibited transaction is subject to: 1) a 10 percent penalty tax on the amount involved in the transaction and 2) a 100 percent penalty tax on the amount involved, if the prohibited transaction is not corrected before the earlier of the date the IRS assesses the 5 percent penalty tax, or mails a notice of deficiency with respect to the tax.

Party in Interest Defined

ERISA §3(14) defines "party in interest." In general, a party in interest will include the following:

- The plan sponsor, its directors, officers and employees.
- Fiduciaries, legal counsel and employees of the plan. Fiduciaries include plan administrators, investment managers and trustees of the plan.
- Service providers and their directors, officers and employees.

Certain subsidiaries, affiliates and controlling shareholders of parties in interest are themselves considered parties in interest, as well as relatives of certain parties in interest. ERISA §3(15) defines the term "relative" as a spouse, ancestor, lineal descendant or spouse of a lineal descendant. [See also IRC §4975(e)(2)].

A savings association normally serves in one or more of the party in interest positions. For its own plans, the savings association is the plan sponsor and therefore a fiduciary and may also be a service provider. For outside plans, the savings association may serve as a trustee (fiduciary) or other service provider role. A savings association acting as a custodian is generally not a fiduciary but is a party in interest under ERISA.

Fiduciary Defined

For the most part, the definition of a fiduciary under ERISA in §3(31) is a functional definition. Therefore, a person is a fiduciary to the extent he or she:

- Exercises any discretionary authority or discretionary control respecting management of an employee benefit plan, or exercises any authority or control respecting management or disposition of its assets;
- Renders investment advice for a fee or other compensation (direct or indirect) with respect to any plan assets or has any authority or responsibility to do so; and
- Has any discretionary authority or discretionary responsibility in the administration of a plan.

The Department of Labor has issued several sets of regulations in a question and answer format over the years that relate to the definition of fiduciary. Examiners should refer to §2509.75-5 and 2509.75-8. In particular, examiners should refer to §2509.75-8, D-3, which states that the position of "trustee" is considered to be a "fiduciary" position.

Prohibited Transactions with Parties in Interest - 406(a)

ERISA §406(a) prohibits a fiduciary from causing an ERISA plan to engage in five general types of transactions between the plan and parties in interest, if the fiduciary knows or should know that the transaction constitutes a direct or indirect:

- Sale, exchange or leasing of any property [see ERISA §406(a)(1)(A) and IRC §4975(c)(1)(A)];
- Lending of money or other extension of credit [see ERISA §406(a)(1)(B) and IRC §4975(c)(1)(B)];
- Furnishing of goods, services or facilities [see ERISA §406(a)(1)(C) and IRC §4975(c)(1)(C)];
- Transferring of plan assets to a party in interest or use of plan assets by (or for the benefit of) a party in interest [see ERISA §406(a)(1)(D) and IRC §4975(c)(1)(D)]; and

- Acquiring of plan sponsor's securities or real property. Special exemptions are included in ERISA §407, with different provisions for different types of plans [see ERISA §406(a)(1)(E)] [no parallel IRC provision, but see IRC rules for ESOPs].

Prohibited Transactions with Fiduciaries - 406(b)

ERISA §406(b) prohibits three general types of self-dealing transactions between ERISA plans and fiduciaries, even if done on an arm's-length basis. The fiduciary is prohibited from:

- Dealing with a plan's assets in its own interest or for its own benefit [see ERISA §406(b)(1) and IRC §4975(c)(1)(E)].
- Acting on behalf of a party whose interests are adverse to the interests of the plan, its participants or beneficiaries in any transaction involving the plan [see ERISA §406(b)(2)][no parallel IRC provision].
- Receiving any consideration for itself from any party dealing with the plan in connection with a transaction involving assets of the plan [see ERISA §406(b)(3) and IRC §4975(c)(1)(F)].

ERISA Sections 407 - Investment in Employer Securities and Real Property

ERISA §407 was intended to address Congress' concern that a number of employee benefit plans incurred major losses because they had placed large amounts of assets in employer securities or employer real property. Under ERISA §407, plans may not acquire or hold employer securities or employer real property unless they are "qualifying employer securities" or "qualifying employer real property." Additionally, plans may not acquire employer securities or employer real property if, immediately after the acquisition, the aggregate fair market value of the investment exceeds a statutory limit of 10 percent of the fair market value of all the assets of the plan. The 10 percent limitation of Section 407 does not apply to "eligible individual account plans," which include most 401(k) plans and profit sharing plans [see ERISA §407(b)(1)].

Under DOL §2550.407a-2, "acquisitions" of employer securities and employer real property that are subject to the 10 percent limitation include acquisition by purchase, exchange of plan assets, exercise of warrants or rights or foreclosures of collateral for a defaulted loan. Acquisition of securities as a result of a stock dividend or stock split are not counted towards the 10 percent limitation. In addition, any acquisition or sale of employer securities or employer real property between a plan and a party in interest must meet the conditions of §408(e), which provides that the acquisition, sale or lease be for adequate consideration and that no commission be charged [see also DOL §2550.408e].

An acquisition of employer securities or employer real property that does not meet the requirements of §407 is a prohibited transaction in violation of §406(a)(1)(E) and 406(a)(2).

ERISA §407 defines "qualifying employer securities" as stock, certain interests in publicly traded partnerships, and certain bonds, debentures, notes, certificates or other evidence of indebtedness of the employer or an affiliate. "Qualifying employer real property" is defined in ERISA §407(d)(4).

ERISA Section 408 - Exemptions From Prohibited Transactions

Statutory Exemptions - Certain exemptions from the prohibited transaction provisions are included in §408 of ERISA. A number of these statutory exemptions are applicable to the trust and asset management activities of savings associations. These exemptions are discussed below. Failure to comply with the various

conditions of these statutory exemptions would mean that the transaction is a prohibited transaction in violation of ERISA §406.

Plan Loan Statutory Exemption

Any loans made by the plan to parties-in-interest who are participants or beneficiaries of the plan are exempted from the prohibited transaction rules if such loans:

- are made in accordance with specific plan provisions;
- are available to all participants on a reasonably equivalent basis;
- are not made available to highly compensated employees in an amount greater than the amount made available to other employees;
- have a reasonable rate of return; and
- are adequately secured.

DOL regulations (29 C.F.R. §2550.408b-1) further explain each condition of the exemption. The tax treatment of participant loans made from qualified employer plans to plan participants is contained in the Internal Revenue Code at §72(p). The IRS issued final regulations on July 31, 2000 at 65 FR 46588, which make substantial changes to the treatment of employee benefit plan loans.

When the trust department is acting as trustee or recordkeeper for an employee benefit plan, it may be responsible, on behalf of the plan, for complying with Regulation Z disclosures in connection with employee benefit plan loans to plan participants. An employee benefit plan is deemed to be a creditor for Truth in Lending purposes if it regularly extends consumer credit that is payable in more than four installments, or for which the payment of a finance charge is or may be required and if it is the party shown as the payee on the face of the note evidencing the loan. Truth in Lending requires a plan fiduciary as a creditor to make disclosures to the borrowing participant with respect to certain credit information, including: 1) interest rates; 2) finance charges; 3) amounts financed; 4) payment schedules; 5) demand features; 6) prepayment penalties; 7) late payment fees; and 8) security interest descriptions and charges. The plan must disclose other relevant credit information so that the borrowing participant can compare credit terms from different sources. Regulation Z contains extensive guidance as to which fees are considered finance charges, the calculation of finance charges and requirements applicable to open-end credit and closed-end credit. Most, if not all, plan loans will be deemed to be closed-end credit and subject to the Truth in Lending requirements applicable to such credit. A loan over $25,000, not secured by real property or the borrower's principal dwelling is exempted from Truth in Lending requirements. Thus, larger plan loans may be excluded from complying with the disclosure requirements.

The Services Statutory Exemption

ERISA §406(a)(1)(C) prohibits a party in interest from providing services to an employee benefit plan. Congress provided two statutory exemptions, ERISA §408(b)(2) for necessary services and §408(b)(6), for what are termed "ancillary services" by banks and financial institutions.

ERISA §408(b)(2) [see also IRC §4975(d)(2)] permits a plan to receive office space, legal, accounting or other services from a party in interest. The office space or service must be necessary for the establishment or operation of the plan; it must be furnished under a contract or arrangement that is reasonable; and no more than reasonable compensation may be paid by the plan [see ERISA §2550.408b-2 for important guidance on

the scope of this exemption]. The exemption provides relief only from the prohibitions of ERISA §406(a), and not from §406(b).

ERISA §408(b)(6) permits financial institutions to receive reasonable compensation for the provision of ancillary services, provided the institution has adopted internal safeguards to ensure provision of such services consistent with sound banking and financial practices and specific guidelines are adopted on the extent to which the services will be provided. This exemption, §408(b)(6) provides relief from ERISA §406(a) as well as 406(b)(1) and 406(b)(2) (but not ERISA §406(b)(3)); therefore, it may provide an exemption in cases that would not be covered by ERISA §408(b)(2) [see §2550.408b-6 and 2550.408c-2 (compensation for services)].

Collective Investment Funds (CIFs)

The investment of employee benefit plans in a CIF operated by a party in interest of the plan is a prohibited transaction. ERISA §408(b)(8) [See also IRC §4975(d)(8)] provides a statutory exemption for any transaction between a plan and a bank's CIF, if the investment is a sale or purchase of an interest in the fund, is specifically authorized by the plan or trust agreement or by an independent fiduciary and if the bank receives no more than reasonable compensation. Section 408(b)(8) provides relief from §§406(a)(1)(A), 406(a)(1)(D), 406(b)(1) and 406(b)(2).

Deposits, Interest-Bearing Statutory Exemption

ERISA §408(b)(4) provides a statutory exemption for the investment of plan assets in bank deposits that bear a reasonable interest rate, where the bank is a fiduciary or other party in interest of the plan. The exemption provides relief from ERISA §§406(a)(1), 406(b)(1) and 406(b)(2) but not from §406(b)(3). The exemption may be utilized with respect to own-bank plans or for other plans if the transaction is authorized by the plan or an independent fiduciary. The authorization must identify the bank by name. See §2550.408b-4.

Employee Stock Ownership Plans (ESOPs) - Loans To Plans Statutory Exemption

Examiners may encounter ESOPs sponsored by a savings association or its holding company or ESOPs sponsored by outside organizations for which the savings association serves as trustee or plan administrator. In most ESOPs, the purchase of employer securities is financed through loans guaranteed by one or more parties in interest, known as "leveraging." Leveraged ESOPs involve potential for abuse due to the possible involvement of insiders and the stock's potential lack of marketability. The guarantee of the loan by a party in interest is a prohibited transaction.

ERISA §408(b)(3) [see also IRC §4975(d)(3)] provides an exemption from the prohibited transaction provisions of ERISA §§406(a), 406(b)(1) and 406(b)(2) for loans to an ESOP that are guaranteed by a party in interest, see also §2550.408b-3.

The exemption requires the loan to the plan to be:

- Primarily for the benefit of participants and beneficiaries of the plan (see §2550.408b-3(c) for the tests to determine whether a loan is made primarily for the benefit of participants and beneficiaries [also see IRC §4975(d)(3)(A)]); and
- At a reasonable interest rate (see §2550.408b-3(g)).

A loan that is exempt under §408(b)(3) must be nonrecourse against the plan and the plan may give as collateral only qualifying employer securities (as defined under §407) that were acquired with the exempt loan or that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan.

Prohibited Transaction Exemptions - Class and Individual Exemptions

ERISA §408(a) provides authority for the DOL to issue both class and individual exemptions. These exemptions are in addition to the exemptions provided by ERISA. While class exemptions are applicable to any party that meets the conditions, individual exemptions provide relief only for the party (ies) that requested it. The DOL has issued more than 35 class exemptions and hundreds of individual exemptions.

Before an exemption may be granted, ERISA requires that the DOL find that the exemption is:

- administratively feasible;
- in the interests of the plan, its participants and beneficiaries; and
- protective of the rights of plan participants and beneficiaries.

Class Exemptions

A number of prohibited transactions not specifically covered in ERISA statutory exemptions are particularly relevant to financial institutions such as savings associations. These prohibited transactions, in many cases, have been addressed in class exemptions. Some of these class exemptions are discussed below.

Collective Investment Funds - PTE 91-38

The DOL has issued a class exemption, Prohibited Transaction Exemption 91-38 (PTE 91-38) which provides relief from ERISA §§406(a), 406(b)(2) and 407(a) for: (i) transactions between parties in interest with respect to a plan invested in a CIF and the bank that maintains the CIF, and (ii) acquisitions of employer securities or employer real property by the CIF, provided that the party in interest is not the bank that maintains the CIF or any other CIF maintained by the bank or an affiliate. The transaction must meet one of the following criteria:

- The plan, along with all other employee benefit plans maintained by the same employer, may not hold more than 10 percent of the total of all interests in the CIF. (For transactions occurring between October 23, 1980 and June 30, 1990, the plans could not hold more than 5 percent of the total of all interests);
- The CIF is a specialized fund that invests substantially all of its assets in short-term obligations (one year or less); or
- The PTE requires that the terms of the transaction be not less favorable than terms generally available in an arm’s length transaction between unrelated parties and that the bank adhere to certain recordkeeping procedures.

Brokers Executing Securities Transactions - PTE 86-128

This exemption permits fiduciaries to effect or execute securities transactions for employee benefit plan accounts and to charge reasonable compensation for doing so. The PTE also permits a fiduciary to act and to

charge reasonable compensation for acting in an agency cross transaction as agent for both the plan and one or more other parties to the transaction, except where the fiduciary has discretionary authority on both sides of the transaction.

The effecting or executing securities transactions for a plan by a party in interest would generally fall within the statutory exemption of §408(b)(2), which permits payment of reasonable compensation for services provided. However, §408(b)(2) provides relief only from the transactions prohibited by §406(a). PTE 86-128 was granted to provide relief from the prohibited transaction provisions of §406(b), involving transactions between a plan and a fiduciary.

Certain limitations apply to the relief provided under the exemption. Trustees (except nondiscretionary trustees), administrators and sponsoring employers are not covered, unless they return or credit all profits earned in connection with the securities transaction to the plan. The exemption also does not apply in the case of transactions that are deemed excessive under the circumstances, either in amount or frequency.

The PTE requires satisfaction of conditions including advance written authorization by an independent plan fiduciary, disclosure of information and confirmation of transactions. The conditions are not required in the case of certain IRAs or Keogh Plans.

Special conditions exist for agency cross transactions, which are securities transactions in which the same person acts as agent for both seller and buyer for the purchase or sale of a security. The transaction must be a purchase or sale, without consideration, other than cash payment for a security for which a market quotation is readily available. The price must be at or in between the independent ask and bid prices for the security. Expanded disclosure must be provided with respect to these transactions, including a statement that the person effecting or executing the transaction will have a potentially conflicting division of loyalty and responsibility. These conditions are not required if the person effecting or executing the transaction does not render investment advice to any plan for a fee with respect to the transaction, is not otherwise a fiduciary with investment discretion over the plan assets involved in the transaction and does not have authority over any person who is or proposes to be a fiduciary with respect to such assets.

Special rules also exist for persons, including banks, engaging in a transaction on behalf of a collective investment fund (CIF) in which plan assets are invested. The special rules require, among other things, that a plan fiduciary be provided with certain disclosures and thereafter authorize the transaction. If the special rules are met, several of the conditions of the exemption are waived and, in certain cases, sponsoring employers may rely on the exemption.

Foreign Exchange - PTE 94-20

Prohibited Transaction Class Exemption 94-20 (PTE 94-20) permits banks and broker-dealers to effect foreign currency exchanges and foreign currency option transactions for employee benefit plans for which the banks or broker-dealers are parties in interest. The transactions may be performed only for nondiscretionary accounts and must be directed by an independent fiduciary. Additionally, the transactions must be on terms not less favorable to the plan than the terms generally available in comparable arm's-length transactions between unrelated parties. Other conditions apply regarding written policies and procedures, written confirmations (with specified contents) and appropriate records retained for six years. PTE 94-20 is effective for transactions incurred on or after June 18, 1991. Provisions also are included for transactions prior to that date.

A related class exemption is PTE 98-54 which exempts certain foreign exchange transactions between employee benefit plans and banks or broker-dealers that are parties in interest with respect to the plan upon standing instructions from an independent fiduciary. The permitted transactions are as follows:

- Income item conversions, which are conversions of interest, dividends and other securities distributions into U.S. dollars or other currencies, in an amount equivalent to no more than $300,000 U.S. dollars; and
- *De minimis* purchase or sale transactions, which are purchases or sales of foreign currencies in an amount equal to no more than $300,000 in U.S. dollars, in connection with the purchase or sale of foreign securities.

The exemption contains both retroactive conditions for transactions prior to January 12, 1999, and prospective conditions for transactions occurring after that date. Prospective conditions include the following: (1) arm's-length terms; (2) no discretionary authority, control or investment advice by the bank or broker-dealer with respect to the plan assets involved in the transaction; (3) deadlines for trades following the receipt of good funds and daily establishment of an exchange rate for the trades; (4) advance written authorization by an independent fiduciary; (5) written policies and procedures for handling foreign exchange transactions for plans; (6) written confirmations; and (7) compliance with certain recordkeeping procedures.

Investment in Residential Mortgages - PTE 88-59

Prohibited Transaction Class Exemption 88-59 permits employee benefit plans to participate in transactions related to residential mortgage financing, including commitments for the provision of mortgage financing, receipt of commitment fees, the making or purchase of loans or participation interests and the sale, exchange or transfer of mortgage loans or participation interests prior to the maturity date. The PTE applies to mortgage loans on single or multiple residential dwelling units, such as detached houses, townhouses and condominiums.

The exemption is necessary in the case of plans that engage in mortgage financing transactions with parties in interest. The exemption provides relief only from ERISA §406(a), and not ERISA §406(b).

General conditions exist for relief under the PTE, including:

- Mortgage loans acquired must be "recognized mortgage loans" or participation interests in such loans. "Recognized mortgage loans" are defined as either residential mortgages eligible for purchase by FNMA, GNMA, FHLMC or Federal Housing Administration insured GNMA tandem project residential mortgage loans.
- Loans must be made for the purchase of a residential dwelling unit(s).
- Mortgage loans must be originated by an independent established mortgage lender.
- The price paid or received by the plan must be at least as favorable as available in a similar transaction involving unrelated parties.
- Certain individuals may not be fiduciaries with respect to the plan's decision to engage in the transaction, including developers and builders of the units, lenders and existing owners of the mortgage or participation interests.
- The decision to engage in the mortgage financing transaction must be made by an independent qualified real estate manager.

- The plan must maintain records for the duration of any loan made pursuant to the exemption sufficient to demonstrate compliance with the exemption.

The PTE also contains specific conditions applicable to commitments to purchase either a mortgage loan or a participation interest and for the purchase of participation interests.

Conversion from Collective Investment Funds (CIFs) to Mutual Funds - PTE 97-41

In 1997, the DOL issued Prohibited Transaction Class Exemption 97-41 (PTE 97-41) which provided relief from ERISA §§406(a), 406(b)(1) and 406(b)(2) for the transfer in-kind of plan assets from a CIF to a mutual fund, where the investment advisor or custodian of the mutual fund also serves as a fiduciary of the plan, provided the transfer represents a complete withdrawal of the plan's investment in the CIF. These transactions are also subject to in-kind asset transfer requirements of Securities Exchange Commission Rule 17(a)-7, issued under the Investment Company Act of 1940 [17 C.F.R. 270.17(a)-7]. PTE 97-41 was effective August 8, 1997 and contains provisions for retroactive relief from October 1, 1988 to August 8, 1997.

PTE 97-41 contains several conditions for prospective relief, including the following:

- No sales commissions or other fees may be paid by the plan in connection with purchase of the shares;
- All transferred assets must be securities for which market quotations are readily available, or cash;
- The transferred assets must represent the plan's pro rata share of all the assets of the CIF, except that special rules apply in the case of fixed-income securities;
- The plan must receive mutual fund shares of equal value to the assets transferred from the CIF;
- An independent fiduciary of the plan must receive advance notice of the transaction and certain disclosures, as well as written confirmations of the transactions;
- The independent fiduciary must provide written approval prior to the transaction;
- The investment advisor must receive no more than reasonable compensation for services to the plan and to the fund; and
- All dealings between the plan and the fund must be on terms no less favorable than transactions involving the fund and other shareholders.

As noted above, the PTE does not provide relief for prohibited transactions in violation of ERISA §406(b)(3). However, the PTE provides that a transaction that complies with the exemption is deemed to satisfy certain conditions under PTE 77-4 (which does provide such relief), and therefore may qualify under that exemption if the additional conditions are met. PTE 77-4 provides relief for ERISA §§406(a) and 406(b), including 406(b)(3). Accordingly, a bank that complies with PTE 97-41 may receive an investment management and advisory fee for services rendered to the fund, with respect to the plan's assets invested in the fund if it complies with the additional requirements of PTE 77-4.

Proprietary Mutual Funds - PTE 77-4

PTE 77-4 covers the purchase or sale by a plan of shares of a registered open-end investment company when the investment adviser of the company is also a fiduciary (or an affiliate thereof) with respect to the plan and is not an employer of employees covered by the plan.

The payment of sales commissions in connection with purchases or sales of mutual fund shares covered by the exemption is prohibited. In addition, the plan may not pay "double" investment advisory or investment management fees with respect to the plan assets invested in the mutual fund shares. To satisfy this condition, the plan either must not pay a plan-level investment advisory or management fee with respect to those assets or must receive a credit against its plan-level fee for its pro rata share of investment advisory fees paid by the mutual fund.

The exemption also contains various disclosure and approval requirements. An independent fiduciary must receive a current prospectus of the mutual fund, as well as full and detailed written disclosure of the investment advisory and other fees charged to or paid by the plan and the mutual fund. On the basis of this information, the independent fiduciary must approve the purchases and sales of the mutual fund shares consistent with its fiduciary responsibilities under ERISA. The approval can be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan. If there is any change in any of the rates of fees that were disclosed to the independent fiduciary, the fiduciary must be notified of the change and approve in writing the continued purchase, sale and holding of the mutual fund shares.

PTE 77-4 provides relief from the prohibitions of ERISA §§406(a) and 406(b). The DOL has released two Advisory Opinions (AO) applying PTE 77-4 to banking-related situations. AO 93-12A, dated April 27, 1993 (and also AO 93-13A, dated April 27, 1993) states that the proprietary mutual fund may pay a bank or an affiliate of the bank for secondary services provided to the mutual fund without a waiver or credit for a plan's pro rata share of such fees. Secondary services are defined as acting as a transfer agent or providing custodial, administrative or accounting services. The secondary services fee may be charged as a flat fee, be based on a percentage of fund assets, a function of the number of accounts or on the volume of transactions. Secondary service fees are separately ascertainable from investment advisory fees. The DOL has indicated that PTE 77-4 does not specifically condition exemptive relief on the crediting of fees to plans for services paid by the investment company other than investment advisory services. AO 93-26A provides guidance on how the PTE applies to the use of affiliated mutual funds by IRA and Keogh accounts.

A Thrift's own Employee Benefit Plans Invested in Proprietary Mutual Funds - PTE 77-3

PTE 77-3 provides relief for the acquisition or sale of shares of a registered open-end investment company by an "in-house" employee benefit plan, that is, a plan covering only employees of the mutual fund, the fund's investment adviser, the fund's principal underwriter, or an affiliate of such persons.

The plan may not pay any investment management, investment advisory or similar fee to the fund adviser, underwriter or affiliate, except in the form of investment advisory fees paid by the fund under a proper investment advisory agreement. The plan also may not pay a sales commission in acquiring or selling the fund shares, and may only be charged a redemption fee under certain conditions. Any other dealings with the plan, such as exchanging shares of one fund for a related fund, must be on a basis no less favorable to the plan than such dealings with other fund shareholders.

Overdrafts - PTE 80-26

An overdraft in an employee benefit plan's account may be a prohibited transaction in violation of ERISA §406(a)(1)(B), as overdrafts represent the lending of funds from a party in interest (financial institution) to a plan. The financial institution would be a party in interest either because it is a fiduciary (trustee) or a provider of services to the plan.

The DOL has recognized that most overdrafts are of a temporary nature and not abusive. Overdrafts may occur as the result of failed securities transactions or problems with check clearings. As a result, the DOL provided relief in Prohibited Transaction Class Exemption 80-26 (PTE 80-26) from the restrictions of ERISA §§406(a)(1)(B), 406(a)(1)(D) and 406(b)(2), for interest free loans and other extensions of credit from parties in interest to employee benefit plans. The PTE is effective January 1, 1975. The exemption covers loans or other extensions of credit used for the payment of ordinary operating expenses of the plan, or for a period of no more than three days for a purpose incidental to the ordinary operation of the plan.

Other conditions to the exemption are as follows:

- no interest or other fee may be charged to the plan and no discount for payment in cash is relinquished by the plan;
- the loan or extension of credit must be unsecured; and
- the loan or extension of credit may not be made, directly or indirectly, by an employee benefit plan.

Qualified Professional Asset Managers (QPAMs) - PTE 84-14

Prohibited Transaction Class Exemption 84-14 permits various parties in interest with respect to employee benefit plans to engage in transactions with investment funds in which plans are invested if the investment fund is managed by a “qualified professional asset manager” (QPAM). Investment funds are accounts subject to the discretionary authority of the QPAM, including accounts maintained by an insurance company and trusts maintained by a savings association. The exemption permits savings associations and other parties in interest to avoid costly ERISA compliance reviews for investment transactions under consideration. PTE 84-14 is effective December 21, 1982.

A savings association that has the power to manage, acquire or dispose of the assets of a plan qualifies as a QPAM if it has equity capital in excess of $1,000,000 as of the last day of its most recent fiscal year and acknowledges in writing that it is a fiduciary with respect to each plan that has retained it as a QPAM.

The general exemption of PTE 84-14 applies to ERISA §406(a)(1)(A)-(D) and contains a number of conditions summarized as follows:

- At the time of the transaction, the party in interest may not have, and during the immediately preceding one year may not have exercised, authority over the appointment or termination of the QPAM or the terms of management agreement with the QPAM.
- The terms of the transaction must be negotiated by or under the authority of the QPAM on behalf of the investment fund.
- The party in interest dealing with the investment fund may not be the QPAM or a person related to the QPAM.
- The transaction may not be entered into with any party in interest with respect to a plan, where the assets of the plan (combined with the assets of other plans sponsored by the same employer) managed by the QPAM represent more than 20 percent of the total assets managed by the QPAM at the time of the transaction.
- The terms of the transaction must be at least as favorable to the plan as generally available in an arm’s-length transaction between unrelated parties.

- Neither the QPAM nor a 5 percent owner of the QPAM may be a person who, within the 10 years immediately preceding the transaction, has been convicted or released from imprisonment (whichever is later) as a result of certain felonies.

The exemption does not apply to securities lending (see PTE 81-6); investment in mortgage pools (PTE see 83-1) and investment in mortgage financing (see PTE 88-59).

In addition to the general exemption, PTE 84-14 provides a specific exemption from the restrictions of ERISA §§406(a), 406(b)(1) and 407(a) for the provision of goods or services by a party in interest that is a sponsoring employer to an investment fund managed by a QPAM or for the leasing of space by the fund to a party in interest that is a sponsoring employer. A specific exemption from the restrictions of ERISA §§406(a)(1)(A)-(D) and 406(b)(1)-(2) also is provided for the leasing of space to a QPAM, an affiliate of the QPAM or a person with the authority to appoint, terminate or negotiate the terms of an agreement on behalf of a plan with a QPAM by an investment fund managed by the QPAM. Finally, there is a limited exemption for places of public accommodation. The specific exemptions have conditions and also must meet certain conditions of the general exemption.

Receipt of Services by IRAs and Keogh Plans - PTE 93-33

The DOL's Prohibited Transaction Class Exemption 93-33 permits savings associations to provide certain banking services at reduced or no cost to individuals, and their family members, for whose benefit the IRAs or Keogh plans were established. PTE 93-33 provides relief from ERISA §§406(a)(1)(D) and 406(b), and from the sanctions resulting from application of IRC §4975, including the loss of exemption of an IRA. PTE 93-33 amended and superseded Prohibited Transaction Class Exemption 93-2. The exemption allows savings associations to take deposit balances of IRAs and Keoghs into account when determining eligibility for reduced fees for services. While the term "services" is not defined, the services must be of the type the thrift could offer consistent with applicable federal and state banking law, and must be provided by the thrift or an affiliate in the ordinary course of business to customers who qualify for reduced or no cost banking services but who do not maintain IRAs or Keoghs with the institution. Services may include incidental products of a *de minimis* value provided by third parties.

Other conditions of the exemption include:

- For the purpose of determining eligibility to receive services at reduced or no cost, the deposit balance required by the savings association for the IRA or Keogh must be equal to the lowest balance required for any other type of account which qualifies for the reduced or no cost services.
- The rate of return on the IRA or Keogh plan must be no less favorable than the rate of return on an identical investment that could have been made by a customer of the savings association who does not receive reduced or low cost services.

PTE 93-33 was amended on April 21, 1994 to permit financial institutions to include securities investments (except investments offered solely to IRAs and Keoghs) in determining eligibility for reduced fees.

Securities Lending - PTE 81-6

The lending of securities from employee benefit plans is a fairly common practice. When the lending is fully collateralized, there is little risk and the plan earns additional income from the lending of the securities. Generally, securities lending takes place with a financial institution that is acting as a trustee or investment

manager for the plan and a securities broker or one of their affiliates is providing services to the plan. In such cases, a prohibited transaction in violation of ERISA §406(a) exists because the financial institution or securities broker or the affiliate of either are parties in interest with respect to the plan. Prohibited Transaction Class Exemption 81-6 (PTE 81-6) (as amended 52 FR 18754, May 19, 1987) permits securities lending with parties in interest if certain conditions are satisfied. In addition, Prohibited Transaction Class Exemption 82-63 (PTE 82-63) permits the financial institution to charge a reasonable fee for securities lending services. Conditions of the exemption include:

- neither the borrower nor an affiliate has discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice with respect to those assets;
- the plan must receive as collateral either cash, securities issued by the U.S. Government (its agencies or instrumentalities) or irrevocable bank letters of credit;
- collateral must be provided equal to 100 percent of the market value of the securities lent and if on any day the market value of the collateral is less than 100 percent of the market value of the securities lent, the borrower must deliver additional collateral such that the total collateral equals 100 percent of the market value of the securities lent;
- the borrower must provide the plan with certain financial statements prior to the loan;
- the loan must be made pursuant to a written loan agreement with arm's length terms;
- the plan must receive reasonable fees for the loan of the securities or the opportunity to invest cash collateral and also must retain all income from the securities that were lent; and
- the loan must be able to be terminated by the plan at any time, at which time the borrower shall deliver to the plan certificates for such securities or the plan may apply the collateral to the purchase of equivalent securities.

Advisory Opinions

The DOL also is authorized to answer inquiries regarding ERISA, and does so, in the form of information letters and advisory opinions. When an inquiry is submitted, the institution must supply the information outlined in ERISA Procedure 76-1.

Mutual Funds, Receipt of 12b-1 Fees

Under SEC Rule 12b-1, mutual funds are permitted to pay certain distribution costs from the assets of the mutual fund itself. These payments may take the form of commission-like payments to organizations that generate large numbers of transactions in the mutual fund. Not all mutual funds have 12b-1 arrangements. There are compliance issues regarding the payment of 12b-1 (or shareholder servicing, sub transfer agent and shelf space) fees to the thrift, its operating subsidiaries, service corporations or affiliates from both proprietary mutual funds and third-party (nonproprietary) mutual funds.

ERISA §406(b)(3) prohibits a fiduciary bank from receiving any direct or indirect compensation for itself from a plan's investment in a mutual fund, including the receipt of 12b-1 fees. In addition, a bank acting as trustee is prohibited under ERISA §406(b)(1) from dealing with assets of a plan in a way that would benefit itself. The receipt of 12b-1 fees would seem to come within this prohibition.

Proprietary Mutual Funds

An examiner may find a situation where a thrift or its affiliate is receiving 12b-1 fees from a proprietary mutual fund. First, the examiner should determine if all of the conditions of PTE 77-4 are being met. PTE 77-4 provides relief from the prohibitions of ERISA §406(a) and 406(b) when employee benefit plan assets for which the thrift is a trustee or other fiduciary are being invested in a proprietary mutual fund. There are two DOL Advisory Opinion Letters (AOs) that apply PTE 77-4 to other mutual fund fee sharing arrangements. AO 93-12A, dated April 27, 1993 (and also AO 93-13A, dated April 27, 1993) states that the proprietary mutual fund may pay a bank or an affiliate of the bank for secondary services provided to the mutual fund without a waiver or credit for a plan's pro rata share of such fees. Secondary services are defined as acting as a transfer agent or providing custodial, administrative or accounting services. The secondary services fee may be charged as a flat fee, be based on a percentage of fund assets, a function of the number of accounts or on the volume of transactions. Secondary service fees are separately ascertainable from investment advisory fees. The DOL has indicated that PTE 77-4 does not specifically condition exemptive relief on the crediting to plans, of fees the bank receives from the mutual fund for services rendered to the fund, other than investment advisory services.

So, the DOL has addressed investment advisory fees through PTE 77-4 and secondary services fees through AO 93-12A (and 13A) but has not directly addressed the receipt of 12b-1 fees received by a bank or thrift from a proprietary mutual fund.

In Advisory Opinion 93-12A, dated April 27, 1993, the DOL indicated that at the time PTE 77-4 was granted, the use of a portion of the assets of a registered investment company (mutual fund) to pay distribution expenses (12b-1 fee) was not generally permitted by the SEC. Accordingly, the payment of fees pursuant to a distribution plan adopted in accordance with Rule 12b-1 under the Investment Company Act was not specifically considered by the Department as part of its determination to grant PTE 77-4. (See footnote #4 to DOL Advisory Opinion Letter 93-12A, April 27, 1993). The DOL has gone on to say that it does not believe that the payment of a 12b-1 fee by a fund to a plan fiduciary or its affiliate can be functionally distinguished in many instances from the payment of a commission by the plan in connection with the acquisition or sale of shares in a mutual fund. If an examiner determines that payments of 12b-1 fees from proprietary mutual funds are being received by the thrift or its affiliate, he or she should ascertain whether an opinion of counsel has been obtained, that shows that current law and circumstances permit such payment and distinguishes the fees being received from commissions. The examiner should also determine whether there is a written agreement between the fund and the thrift or its affiliate that is receiving the 12b-1 fees, which describes the services that are being provided by the thrift to the fund.

Nonproprietary Mutual Funds

The DOL has addressed the question of receipt of 12b-1 fees (shareholder services fees, sub transfer agent fee and/or shelf space) in two advisory opinion letters and one information letter.

The first main advisory opinion letter is 97-15A, dated May 22, 1997 (Frost National Bank opinion letter). Frost presented two situations to the DOL. One was where it was acting in a discretionary capacity. In this situation, Frost was making recommendations to plan sponsors regarding the advisability of investing in the various mutual funds that Frost offered as part of its 401(k) product. In the other situation, Frost was acting as a trustee to 401(k) plans but was not making any recommendations concerning the selection of, or continued investment in, particular mutual funds. The selection of the mutual funds to offer to participants was made, in all cases, by the plan sponsor after reviewing the funds Frost had available as part of its 401(k) product.

Frost asked whether its receipt of fees from the mutual funds would violate ERISA §406(b)(1) or (b)(3). The DOL in its opinion indicated that since Frost is a trustee in both discretionary and nondiscretionary situations, it is a fiduciary. In fact, the opinion states, "…the position of trustee of a plan, by its very nature, requires the person who holds it to perform one or more of the functions described in ERISA §3(21)(A)." Footnote #6 which follows this statement is as follows:

> Section 403(a) of ERISA establishes that, in general, a trustee of a plan must have exclusive authority and discretion to manage and control the plan's assets. Under §403(a)(1), when the plan expressly so provides, the trustee may be subject to the proper directions of a named fiduciary which are made in accordance with the terms of the plan and not contrary to ERISA. Nevertheless, a directed trustee has residual fiduciary responsibility for determining whether a given direction is proper and whether following the direction would result in a violation of ERISA. Accordingly, it is the view of the Department that a directed trustee necessarily will perform fiduciary functions.

The DOL concluded that when Frost is acting in a discretionary capacity, i.e. advising the plan sponsor regarding the various mutual funds in its 401(k) product menu and receives 12b-1 fees from the mutual funds the plan participants are invested in, then Frost is in violation of ERISA §406(b)(1). However, the DOL said that Frost could extinguish its prohibited transaction violations by disclosing to the plan the extent to which it may receive fees from the various mutual funds. In addition, Frost would have to offset on a dollar per dollar basis any fees it receives from the mutual funds against any fees that the plans owe to Frost. Any fees that Frost receives from the mutual funds that exceeds the plan's liabilities to Frost, will go to the plan.

When Frost is directed by the plan or the plan participants, there is no violation of either ERISA §406(b)(1) or §406(b)(3) whether Frost offsets the fees from the mutual fund against the plan's trustee fee or not. But, since Frost reserved the right to add or remove mutual fund families from its 401(k) product, there is a violation of §§406(b)(1) & 406(b)(3). Frost extinguishes its prohibited transaction violations by off-setting dollar for dollar the fees it receives from the mutual funds against the plan's fees owed to Frost or Frost could choose to credit directly to the plan, the fees received from the mutual funds.

In the Frost letter, the DOL also noted that the general standards of fiduciary conduct stated in ERISA §404(a)(1) require the plan fiduciary to determine that the compensation paid directly or indirectly by the plan to its trustee is reasonable, taking into account the services provided to the plan as well as any other fees or compensation received by the trustee in connection with the investment of plan assets. The DOL emphasized that plan fiduciaries must obtain sufficient information regarding any fees or other compensation that the trustee receives with respect to the plan's investments in each mutual fund to make an informed decision as to whether the trustee's compensation for services is no more than reasonable. In addition, plan fiduciaries are required to periodically monitor the actions taken by the trustee in the performance of its duties, to assure, among other things, that any fee offsets to which the plan is entitled are correctly calculated and applied.

The situation in the next advisory opinion letter on 12b-1 fees was very different. In 97-16A, dated May 22, 1997 (the Aetna letter) the DOL looked at whether a nonfiduciary, such as a recordkeeper could retain 12b-1 fees received from third-party mutual funds without an offset. In all situations that Aetna presented to the DOL, the plan participants were making the selection of which mutual fund to invest in and the plan sponsor was choosing which mutual funds (from those available in Aetna's 401(k) product) would be made available to the plan participants in their 401(k) program.

The first question that the DOL faced was whether Aetna was a fiduciary. The DOL referred to Interpretive Bulletin (IB) 75-8 that provides guidance concerning what types of functions will make a person a fiduciary with respect to a plan. Based on the information provided in the IB, the DOL stated that the question of whether Aetna is a fiduciary within the meaning of 3(21)(A) of ERISA is inherently factual and depends on the particular actions or functions that Aetna performs on behalf of the plans. The DOL found that since Aetna was not a trustee or administrator of the plan and provided only administrative and recordkeeping services, it was not a fiduciary. However, the DOL was concerned with the fact that Aetna retained the right to delete or substitute mutual funds in its 401(k) product list. The DOL determined that normally this would make Aetna a fiduciary, however, since Aetna provided advance notice of any mutual fund changes in its product list, including any changes in the fees received and afforded the plan sponsor a reasonable period of time within which to decide whether to accept or reject the change and, in the event of a rejection to secure a new service provider; Aetna would not become a fiduciary solely as a result of deleting or substituting mutual funds, provided that the actual decision to accept or reject the change is made by the plan.

The DOL closed its advisory opinion letter by reiterating the general fiduciary concerns it expressed in the Frost letter.

In an informational letter dated August 20, 1997 and addressed to Judith McCormick , Senior Trust Counsel of the American Bankers Association, the DOL indicated that if a fiduciary, such as a directed trustee, that retained the right to add or delete mutual funds from its 401(k) product menu and did not want to offset dollar for dollar any 12b-1 or other fees it received from mutual funds would have to follow the conditions as laid out in the Aetna advisory opinion letter.

Float Management

In advisory opinion letter 93-24A, dated September 13, 1993 the DOL addressed the question of whether a bank acting as an agent or trustee for employee benefit plans can earn interest for its own account from the "float" when a benefit check is written to a participant until the check is presented for payment. The question was asked by a nondeposit trust company that maintained a disbursement account at a national bank. The trust company and the bank had a retail repurchase agreement that allowed the trust company to earn (for its own benefit, not that of the plan) interest on the funds held in the disbursement account until they were released when checks were cashed.

The question asked of the DOL was whether this practice was a violation of §406(b)(3) of ERISA. The trust company contended that once a check is written to a participant, the corresponding amounts in the disbursement account were no longer plan assets.

The DOL first asked the question of whether the trust company was a fiduciary. The DOL looked to §3(21)(A) of ERISA, which defines a fiduciary, in part, as one who exercises any discretionary authority with respect to the assets of a plan. The DOL then went on to look at 29 C.F.R. 2509.75-8 which states that persons serving as plan trustees will be fiduciaries due to the very nature of their position. Then the DOL stated:

> Accordingly, it is the view of the Department that, based on the facts described above, where a fiduciary (e.g. Trust Company) exercises discretion with regard to plan assets, its receipt of income from the "float" on benefit checks under a repurchase agreement with a national bank in connection with the investment of such plan assets would result in a transaction described in ERISA §406(b)(1).

Although asked, the DOL declined to address the question of whether the trust company had also violated ERISA §406(b)(3).

The DOL then addressed the subject of float in an informational letter addressed to Judith McCormick, Federal Counsel of the American Bankers Association dated August 11, 1994. In the letter, the DOL indicated that if a bank acting as trustee openly negotiated with the plan sponsor to retain earnings on the float as part of its overall compensation, the bank's use of the float would not violate the prohibited transaction rules. The DOL suggested that to avoid problems, banks should, as part of their fee negotiations, provide full and fair disclosure regarding the use of float on outstanding benefit checks.

Sweep Fees

Savings associations acting as trustees or investment managers to employee benefit plans may agree to provide "sweep services" to such plans. Sweep services involve investing excess uninvested cash of a plan into either a deposit account or other short-term investment vehicle. Depending on how the arrangement is structured, provision of sweep services may involve one or more prohibited transactions under ERISA §406. In some cases, the statutory exemptions of ERISA §408 may provide a safe harbor.

The primary guidance regarding sweep services is contained in DOL Advisory Opinion, AO 88-02A and a DOL information letter issued to Robert S. Plotkin, dated August 1, 1986 (the Plotkin Letter). The general rule established under these letters is that a bank, which has the authority to decide whether a sweep transaction should be performed and which levies a separate fee for this service is in violation of ERISA §406(b). Section 406(b)(1) [see also IRC §4975(c)(1)(E)] is applicable because the bank is exercising its discretionary authority to cause the plan to pay an extra fee. Section 406(b)(2) is applicable because the bank is charging a fee for the sweep transaction that is adverse to the interest of the plan or the plan's participants and beneficiaries.

The DOL letters clarify that a bank may provide sweep services under the following circumstances:

- If no fee is charged (other than direct expenses properly and actually incurred in the performance of services). [Plotkin Letter].
- If investment services, including sweep services, are provided under a single fee arrangement that is calculated as a percentage of the market value of the total assets under management. [Plotkin Letter].
- If a for-profit fee is charged, provided that a fiduciary independent of the bank (such as the plan sponsor, plan administrator, or outside investment manager) (i) authorizes either individual sweep transactions or authorizes a standard procedure as to when and how sweeps will occur in order to eliminate any discretion on the part of the bank; (ii) authorizes the investment vehicle(s); (iii) is permitted to terminate the sweep arrangement at any time without penalty; and (iv) receives notice from the bank not less than 30 days prior to any change in sweep fees.

Soft Dollars

The term "soft dollars" refers to the practice whereby the investment manager of a discretionary account pays more than the absolute minimum commission in placing securities transactions with a broker. In return, the investment manager receives research services paid for by the excess commissions. Section 28(e) of the Securities Exchange Act of 1934 permits this practice and authorizes a "safe harbor" if bona fide research services are provided.

The DOL's Technical Bulletin 86-1, indicates that soft dollar transactions, which meet the safe harbor of Section 28(e), do not represent a prohibited transaction under ERISA. However, those that do not fall within Section 28(e) would represent a violation of ERISA §§406(a)(1)(D), 406(b)(1) and 406(b)(3).

ERISA - Miscellaneous Provisions (Sections 409, 410, 411 and 412)

Section 409 states that any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations or duties imposed upon fiduciaries shall be liable to make good to such plan any losses to the plan resulting from each breach, shall restore to the plan any profits of a fiduciary which have been made through use of plan assets and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of the fiduciary.

Some employee benefit plans contain exculpatory clauses or indemnification agreements in the plan document or trust instrument. These clauses attempt to relieve the trustee from liabilities from certain described actions. They may attempt to permit a trustee to adhere to a lesser standard than required by law. Section 410(a) of ERISA states that "any provisions in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation or duty shall be void as against public policy" (the only exception is that fiduciaries may allocate and delegate responsibilities under §405). DOL Interpretive Bulletin 75-4 permits indemnification agreements that leave the fiduciary fully responsible and liable for its actions, but allow another party to satisfy any liability incurred by the fiduciary (i.e. liability insurance). At least one court has ruled on indemnification language. In the case of Reich v. NationsBank of Georgia, 2138 N.D. Ga. 1993, which is also known as the "Polaroid" case, a federal district court held that common law trust principles invalidate indemnification agreements that tend to induce a breach of the fiduciary's trust. The court went on to say that the indemnification provision contained in the ESOP agreement (which was at issue in the case) "creates a financial incentive for the trustee to breach its fiduciary obligations under ERISA" because, if the trustee exercised independent judgment it would be left unprotected against charges of negligence, bad faith or willful misconduct.

Section 410(b) of ERISA permits plans to purchase insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of an act or omission. The policy must be payable to the plan and provide that the insurance company may take recourse against the fiduciary for breaches of fiduciary responsibility. Individual fiduciaries may also purchase insurance that would protect them against personal liability.

Section 411 prohibits any person convicted of or imprisoned as a result of a conviction of certain specific crimes (such as embezzlement, bribery or extortion, etc.) to serve in any capacity with regard to an employee benefit plan during or for the period of five years after such conviction or after the end of such imprisonment.

Finally, ERISA §412 requires that, in general, each fiduciary or other person who handles funds or other property of the plan must be bonded. Bonding protects the plan against fraud or dishonesty. Corporate fiduciaries with $1,000,000 or more in capital are exempted from these provisions. The amount of the bond is 10 percent of the assets handled, with a minimum of $1,000 and a maximum of $500,000.

Referrals to the Department of Labor

The Federal Financial Institutions Examination Council (FFIEC) and the Department of Labor have signed an agreement (Interagency Referral Agreement for ERISA Violations) under which significant possible violations of ERISA are to be referred to the DOL by OTS and the other federal regulatory agencies. Generally, referrals are to be made for possible violations relating to fiduciary duties (§404) and prohibited

transactions (§406). In addition, the violations must affect transactions of $100,000 or more and must pose a threat to plan assets, participants or beneficiaries.

- The DOL forwards any referrals to be investigated to its appropriate regional office for review. The written notification to the DOL is to include the following: 1) the name of the financial institution; 2) the name of the plan; and 3) a brief description of the nature of the possible violation and any corrective action requested by the OTS and/or initiated by the OTS.

In order to provide for the orderly processing of any such possible referrals and to assure national uniformity, potential referrals should be forwarded to the Examination Policy section of OTS in Washington, D.C., for review prior to making the referral.

Participant Recordkeeping

While many institutions perform participant recordkeeping services in-house for individual account defined contribution employee benefit plans as part of their product or service to employee benefit plan customers, some institutions have assigned these responsibilities to recordkeeping specialists that may be affiliates, third parties or, in the largest trust institutions, to separate departments. With the increasingly complex regulatory requirements in processing and reporting of plan transactions, many savings associations have used these specialists to receive and process transactions, value the assets held by the plan (whether daily, monthly, quarterly, semiannually or annually), perform participant recordkeeping for loans, regulatory and participant reporting, do compliance testing and to update the plans with recent regulatory changes. It is important for the examiner to review the servicing agreements between the parties, to assess the technical expertise of these service providers and to evaluate the controls used to mitigate the heightened legal and operational risks associated with this function. The sufficiency of the savings association's oversight of the service provider should also be assessed.

Employee Benefit Accounts Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's provision of products and services to employee benefit accounts. Consider whether:

- effective policies, procedures and internal controls have been established;
- there is adequate expertise to effectively support the provision of products and services to employee benefit accounts;
- the legitimate needs of plan participants, beneficiaries and other interested parties are provided for in a professional and timely manner;
- policies and procedures ensure compliance with governing instruments, applicable law and accepted fiduciary principles; and
- deficiencies are identified and corrective action promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products or services have been introduced. If items of concern are uncovered during Level I procedures, or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the provision of products and services to employee benefit accounts. Scoping material should include:

    - Risk profile
    - Relevant PERK documents
    - Previous trust and asset administration examination report

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

Wkp. Ref.

- Workpapers from the previous examination
- Copies of any prototype plans used by the savings association
- Board and other appropriate committee minutes
- Examination reports of subordinate, functionally regulated entities

2. Assess whether management and staff have the expertise to effectively support the provision of products and services to employee benefit accounts. Note any significant changes in personnel since the previous examination.

3. Note the types, capacity and volumes of employee benefit accounts currently found in the trust department. Identify any significant changes as well as any changes in product or service offerings since the previous examination.

4. Review policies, procedures and practices related to the provision of products and/or services to employee benefit accounts and note any changes since the previous examination. Determine their adequacy relating to:

- Preacceptance reviews;
- Acceptance of accounts, including successor appointments;
- Administration of accounts (including acceptance of contributions, payment of plan expenses and distributions to participants and beneficiaries);
- Periodic account reviews;
- Identifying, preventing, correcting and reporting prohibited transactions;
- The filing of Form 5500 as a service to plans or the provision of information for inclusion on the plan's Form 5500;

Exam Date:
Prepared By:
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Docket #:

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- Compliance with DOL guidelines in connection with the acceptance of 12b-1 or other fees from proprietary or third-party mutual funds;
- Termination of accounts or of plans;
- Use of proprietary products in discretionary accounts;
- Providing plan participant investment educational material, voice response units or internet capabilities for plans and plan participants; and
- Compliance with applicable law and accepted standards of fiduciary conduct.

5. If administrative or investment functions have been outsourced to third parties, assess the selection and oversight process. Review the servicing contracts to ensure that all activities are covered including the fee arrangements.

6. If a bundled product is offered and participant recordkeeping is outsourced, review the servicing contract and determine if management monitors the vendor's performance.

7. Determine if the trust department provides services for the savings association's own employee benefit plan. Are policies and procedures adequate to comply with Department of Labor and ERISA requirements regarding the savings association's fiduciary responsibilities to the plan and what the trust department may charge for the services being provided?

8. Assess the adequacy of policies and procedures for participant loans, particularly as they relate to IRS, ERISA and (if applicable) Regulation Z's Truth in Lending requirements.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

9. Determine if effective policies and procedures have been adopted for identifying fiduciaries, parties in interest and prohibited transactions in qualified plans.

10. Determine if policies and procedures are in place regarding investment allocation instructions for plans directed by individual participants or plan appointed investment managers.

11. Do policies and procedures address IRS determination letters and plan funding?

12. Consider whether the following risk contributors (if applicable) have been addressed:

- Management fully understands all aspects of risk associated with employee benefit accounts
- Adequate policies, procedures, practices and internal controls are confirmed for administrative practices
- Administrative policies, procedures and practices are consistently applied
- Comprehensive risk management, audit and compliance systems are established and utilized effectively
- Management reports are generated and utilized appropriately
- Management and administrative personnel are familiar with account details
- Sufficient documentation is maintained
- Significant employee benefit account issues that were noted in audit, compliance or examination reports are resolved timely

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents, such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures involve significant verification.

1. Determine if procedures require that necessary approvals, notifications or registrations are filed for new service or product offerings.

_______________________________________ ____________

2. Review new business development reports (including both accepted and rejected accounts). Determine whether the savings association performs a preacceptance review of accounts prior to their approval.

_______________________________________ ____________

3. If the savings association administers Keogh and IRA accounts and has not been granted trust powers, review policies and procedures for compliance with 12 CFR §545.102 and other applicable OTS and IRS regulations.

_______________________________________ ____________

4. Does the savings association have a policy and procedure for identifying and making a reasonable effort at remedying any breach by cofiduciaries?

_______________________________________ ____________

5. Ensure that the savings association has a policy for ensuring that all nonsavings association parties who handle funds or other property under the control of the savings association are bonded.

_______________________________________ ____________

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

Wkp. Ref.

6. Ensure that the savings association has a policy and procedure for prohibiting any person from serving in a fiduciary capacity if that individual has been convicted of specific crimes.

____ __________

7. Review and verify the accuracy of any applicable management exception reports. Evaluate management's expediency in handling exceptions.

____ __________

8. Review the process for certifying the information required by the plan administrator to file a Form 5500 or to publish an annual report.

____ __________

9. Does the saving association's ensure that loans made to participants are in compliance with applicable provisions of ERISA and the Internal Revenue Code? Consider if:

- loan balances and repayment are limited;
- level amortization is required;
- loans are available to all participants and beneficiaries;
- loans are made according to specific provisions in the plan;
- loans bear a reasonable rate of interest; and
- delinquencies are monitored.

____ __________

10. If the savings association provides services to its own employee benefit plan, is there a process in place to readily identify any prohibited transactions?

____ __________

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

Wkp. Ref.

11. If there are unresolved exceptions from internal or external audit reports, compliance reports or examination reports, discuss corrective action with management.

12. If the savings association services its own or affiliated plans, determine if the use of proprietary or affiliated products is done in the best interest of the participants.

13. Determine if plan fiduciaries and parties in interest are identified and their activities regarding plan assets are adequately monitored.

14. For plans covered by ERISA 404(c) determine that at least three investment choices are made available and that plan participants are given sufficient information to make informed investment decisions.

15. Determine if plans are timely and adequately funded.

16. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I and Level II procedures or data contained in department records or internal or external audit reports to form a conclusion, proceed to Level III.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of accounts for review. A suggested sample might include a selection of new, seasoned and closed accounts that has coverage from all administrative personnel and all business locations. Also consider in the sample:

   - accounts in which litigation is pending or has been threatened;
   - accounts for which complaints have been lodged with the savings association; and
   - accounts that exhibit identifiable concerns.

2. Determine whether the trust department has exclusive authority and discretion to control and manage the assets of the sampled plans/accounts. If it does not, ensure that the plan/account expressly:

   - states that the trustee is subject to the proper direction of a named fiduciary who is not the trustee; or
   - provides for the naming of a qualified investment manager pursuant to provisions of the plan/account.

3. Review new accounts to determine whether adequate account acceptance procedures are utilized, committee approvals are obtained, necessary documents are acquired and synoptic information sheets are prepared.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

4. Review successor appointments to determine whether acts of prior fiduciaries are reviewed, assets are properly received and other appropriate documentation is obtained.

5. Review accounts that utilize third-party administrators or are directed by other named fiduciaries or investment managers. Determine whether necessary authorizations or directions are obtained and on file, that they are proper according to the terms of the plan and not contrary to the provisions of ERISA.

6. For plans/accounts which own assets outside the jurisdiction of the United States, determine if the trust department ascertains that the indicia of ownership of such assets is in accordance with DOL regulations (20 CFR §2550.404b-1).

7. Review committee minutes and file documentation to ensure that initial, annual and closing account reviews are complete, adequately documented and performed in a timely manner.

8. Review account administration practices for employee benefit accounts to determine compliance with the terms of governing instruments, applicable law and accepted principles of fiduciary conduct.

9. Review asset holdings and account activities for prohibited transactions. If prohibited transactions are identified, determine if an exemption exists and procedures are in effect to assure compliance with the exemptions. If no exemption exists, assess management's efforts to remedy the situation.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

10. Review a sample of employee stock ownership plans (ESOPs) to determine compliance with internal policies and procedures as well as ERISA §§407 and 408. Include loans to ESOPs made or guaranteed by a party-in-interest if any exist.

11. Review a sample of plans that invest in employer securities and real property to determine compliance with internal policies and procedures as well as ERISA §§407 and 408.

12. Review closed accounts or plans to determine whether accounts were closed in accordance with established procedures and supported by documentation. Ensure that appropriate documentation of IRS and PBGC notification and approval is received prior to making a distribution of plan assets. (See IRS Publication 1048). Ensure that assets have been transferred in a timely manner.

13. During the account review, determine if investments support the plan's funding policy (§402(b)(1)). Also determine if there is diversification of fund investments (§404(a)(1)(c)).

14. Select a sample of employee benefit accounts holding qualified employer securities and real property and test the saving association's process for monitoring and controlling the purchase or retention of these assets.

15. Select a sample of accounts and review for impermissible assets.

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

16. Select a few accounts reviewed by the audit and/or compliance functions and determine if the findings of the audit/compliance review are consistent with examination findings. If not, discuss the reasons for any discrepancy with management.

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 730P

Law

Internal Revenue Code	Section 72
	Sections 401-414
	Section 501

Employee Retirement Income Security Act of 1974 (ERISA)
Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)
Economic Growth and Tax Relief Reconciliation Act of 2001

Code of Federal Regulations

12 CFR 550	Trust Powers (General)
12 CFR 550.410	Recordkeeping
29 CFR 2550	DOL Regulations
29 CFR 54.4975	Stock Bonus Plans

Office of Thrift Supervision Publications

FHLBB Resolution 86-277 Exercise of Trust Powers

Other

Internal Revenue Code Sections 72, 407, 408
IRS Publication 1048
PTCE 77-3,77-4,80-26,81-6,82-63,83-1,84-14,85-68,86-128,91-38,91-55,93-1,93-33,94-20,97-41
DOL Advisory Opinions 88-02A,93-12A,93-13A,93-24A,97-15,97-16

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

DOL Technical Bulletin 86-1

Workpaper Attachments - 730P

Exam Date: ________________
Prepared By: ________________
Reviewed By: ________________
Docket #: ________________

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Preacceptance Review

• Do policies and procedures require that specific documents be obtained in order for an account to be opened?
• Is the nature and complexity of the account considered, including the ability of trust personnel to properly administer it?
• Are real or potential conflicts of interest considered?
• Is the potential profitability of the account considered?
• Is an account opening checklist used?
• When appropriate, are potential environmental issues considered?
• Is an IRS determination letter obtained?

Account Acceptance

• Have guidelines for account acceptance been established?
• Are the assets of all new accounts reviewed within 60 days of acceptance?
• Does the board of directors or its designated committee approve all new accounts?
• Is the approval documented in the appropriate minutes?
• Are original or certified copies of governing instruments obtained?
• Are other supporting documents obtained as necessary?

Successor Appointments

• Is proof obtained of the prior trustee's removal or resignation?
• Are the prior trustee's activities reviewed?
• Are procedures in place to ensure that all assets have been received?
• Does the department obtain indemnification from the prior trustee and/or the account beneficiaries for activities of the prior trustee?
• Is an account statement obtained from the prior trustee indicating a zero balance in the account?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Account Administration

• Does the trust department, when acting as trustee, ensure that each account is established and maintained pursuant to a governing instrument which: • Designates or provides for one or more named fiduciaries? • Describes how the plan will be funded? • Details how fiduciary responsibilities will be allocated? • Contains procedures for amending the plan? • Provides that all assets of a plan/account are to be held in trust by one or more trustees?
• Do procedures require that proxies are voted solely in the best interests of account beneficiaries?
• Is a system in place to assure required deadlines are met?
• Does the trust department certify within 120 days after the end of a plan's fiscal year end the information required in order to publish an annual report, including: • Information pertaining to any party-in-interest transactions? • Reportable transactions in excess of 3 percent of the current value of plan assets? • Past due leases and loans?
• Are adequate recordkeeping procedures and controls in place?
• When required, are directions or approval from cofiduciaries timely received in writing?
• Are appropriate approvals by the board of directors or its designated committee obtained and documented?
• Are procedures in place designed to ensure updated account documents are timely received?
• Are closed accounts timely removed from the accounting system?
• Are informational returns timely and accurately filed?
• Are procedures in place to ensure contributions are timely received?

Cofiduciaries

• Are the acts of cofiduciaries reviewed for appropriateness?
• Are appropriate controls in place to ensure inappropriate acts by cofiduciaries are not concealed?
• Do procedures in place to correct a known breach by a cofiduciary?
• Do policies require that all plan assets be under the control of the trust department?

Exam Date: ________________
Prepared By: ________________
Reviewed By: ________________
Docket #: ________________

Account Reviews

- When applicable, are procedures in place to ensure that annual account reviews are timely performed?
- Are closed accounts timely reviewed and ratified by the board of directors or a designated committee?
- Are account reviews sufficiently documented and approved?

Terminations

- Is proper documentation obtained at the time an account is closed?
- Do procedures require that assets be timely distributed?
- Are receipts obtained and maintained when assets are transferred?
- Are account closings reviewed and termination approvals recorded in appropriate committee minutes?
- Are closed accounts promptly removed from the trust accounting system?

Employee Stock Ownership Plans

- Does the governing instrument formally designate the account as an ESOP?
- Does the plan specifically state that it is designed to invest primarily in qualifying employer securities?
- When appropriate, does the plan provide for put options?
- Are distributions made only in stock of the employer or cash?
- When transactions involve qualifying employer securities which are not publicly traded, is a good faith determination of fair market value made:
  - By an experienced and independent appraiser?
  - At least annually and as of the transaction date, if the transaction involves a party-in-interest?
  - By considering other relevant factors, if the transaction involves a party-in-interest?

Loans to ESOPs

- Is the loan primarily for the benefit of participants and beneficiaries?
- Is the interest rate reasonable?
- Does collateral consist solely of qualifying employer securities?
- Are the terms of the loan at least as favorable as the terms of comparable loans resulting from arm's length negotiations between independent parties?
- Are loan proceeds used only to acquire qualifying employer securities or to repay an outstanding loan of the ESOP?
- As the loan balance declines, is an appropriate amount of collateral released?

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

Employer Securities and Real Property

- Does the plan acquire or hold employer securities or real property?
- Does the aggregate holding of a defined benefit plan exceed 10 percent of the fair market value of the plan's assets?
- If an eligible individual account plan holds employer securities or real property in an amount that exceeds 10 percent of the fair market value of the assets of the plan, is there language in the plan permitting this?
- Are transactions involving the acquisition or sale of qualifying employer securities and real property (including the lease thereof) entered into:
  - For adequate consideration?
  - Without charging a commission?
- Are purchases of qualifying employer securities or real property considered prudent?

Prohibited Transactions

- Does the trust department have procedures to identify persons or entities that are parties-in-interest as defined by ERISA?
- Did transactions with a party-in-interest involved the:
  - Sale, exchange or lease of property?
  - Lending of money or other extension of credit?
  - Furnishing of goods, services or facilities?
  - Transfer to, or use of assets by or for the benefit of such party?
- Did the trust department:
  - Deal with plan assets for its own account or in its own interest?
  - Act in any capacity involving a plan on behalf of a party whose interests are adverse to those of the plan, its participants or beneficiaries?
  - Identify and monitor fiduciaries and parties in interest?

Exemptions From Prohibited Transactions

- Are participant loans:
  - Available to all participants and beneficiaries on a reasonably equivalent basis?
  - Not made available to highly compensated employees, officers or shareholders in an amount greater than the amount made available to other employees?
  - Specifically authorized in the governing instrument?
  - Made at a reasonable rate of interest?
  - Adequately secured?

Exam Date: ______________
Prepared By: ______________
Reviewed By: ______________
Docket #: ______________

- In amounts not in excess of established limits?
- Subject to level amortization and repayment at least quarterly over no more than five years (unless when used to acquire a principal residence)?
- Subject to a written loan agreement?
- Treated as a distribution if delinquent, including the issuance of a 1099R?
- If applicable, in compliance with Reg. Z?

- If parties in interest provide ancillary services, is the amount paid for these services reasonable?
- If plan assets are invested in interest bearing deposits of the savings association or an affiliate:
  - Is a reasonable and competitive rate of interest paid?
  - Are the deposits specifically authorized by the plan or directed by an authorized individual?
- If any ancillary services are provided by the savings association:
  - Is the service provided in the best interests of the participants?
  - Are the costs for such services reasonable?
- If plans/accounts participate in the trust department's common or collective funds or pooled investment funds:
  - Are associated fees reasonable?
  - Is the participation specifically authorized by the plan or directed by an authorized individual?
  - Does the fund permit investment by these accounts?
- Are hardship withdrawals permitted only under the terms of the plan?
- Are hardship withdrawals permitted only after the ability to use participant loans is exhausted?

Keogh and IRA Accounts

- If the trust department is performing any services greater than a custodian, are they authorized to act in that capacity?
- Are only permitted investments held by the accounts?
- If the savings association offers premiums, "finders fees," or related incentives to third parties in connection with establishing IRA accounts, does it conform to conditions specified by the OTS, DOL and IRS for such payments?

Qualified Investment Manager

- Did the appropriate fiduciary name the qualified investment manager in accordance with the provisions of the plan?
- Was a statement obtained appointing the specific investment manager?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

- Was a statement obtained from the specific investment manager acknowledging its status as a fiduciary?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Introduction to Private Banking

Many savings associations offer "private banking" services with oversight provided by the trust department. These services may also be known as "wealth accumulation," "wealth management," "family wealth" or "private financial services." For the purpose of this discussion, the term "private banking" will be used.

Private banking offers convenient, responsive and personalized service along with a special package of financial services designed to meet the credit and investment needs of individuals. In the past, private banking was exclusively for the very wealthy or for those seeking a safe haven offshore for their capital. It is now undergoing a massive change from a once quiet and discrete service to a highly dynamic and competitive business. Today's private bankers are dealing with very active money, as shown by an increased movement of money from onshore to offshore.

There is no typical private banking client but generally they can be divided between the old-line, wealthy families (the traditional private banking customers) and the "nouveau riche," that is, self-made millionaires who have profited from mergers and acquisitions, the dot.com revolution, lotteries or the real estate boom. After a decade of unprecedented economic growth, this second group is larger and more attractive as potential customers. The business of handling and managing personal wealth is growing between 15 to 20 percent each year.[1]

The relative stability of client revenues and the lower level of credit risk is elevating private banking to the top of the financial industry's list of target markets. The offering of these services is no longer the exclusive domain of large commercial banks. Competitors now include investment banks, thrifts, insurance companies, lawyers and accountants. Not only is it easier to make a profit on the large sums of money involved but private banking customers tend to remain loyal to trusted advisers.

Private bankers are starting to prepare for and cater to, a new generation of private investors who want to participate in the management of their money and receive high returns from diversified investments. The transformation of the client base is forcing private bankers to offer new investment packages and services. Clients want brokerage services, advisory services on investments, stock options, taxes, margin loans and off shore havens. They want quick and easy ways to obtain credit, advice on how to transfer money to family or nonprofit groups, checking accounts and other typical banking services, along with estate planning and trust services. These clients also increasingly want all these services in one place. Private banking has become a place where the wealthy have access to expertise on all lines of financial services as well as an elevated level of personal service. The goal of the private banker is to satisfy the needs and objectives of each client in the context of their life. The private banker not only offers advice on how to create and grow wealth, but also on how to protect, preserve and distribute wealth.

Private banking clients look for advice from people who deal with other wealthy individuals. Rather than having multiple bank representatives deal with a customer, a single private banking representative, commonly referred to as a relationship manager (RM), delivers most, if not all, of the private banking services to the client. The RM is the client's primary contact and provides a high level of support and service to the client. The RM is generally charged with understanding and anticipating the needs of the client and recommending services and products. The RM strives to provide a high degree of confidentiality, support, service and investment opportunities while maintaining long lasting, strong relationships that provide a stable

[1] The Washington Post, November 26, 2000, H01, "The Private Banking Boom"

stream of fee income to the private banking institution in good times and bad. Because of this close relationship, clients often delegate a great deal of authority and discretion to the RM.

A major concern to the private banking operation is that RMs may take accounts with them if they change employment. Another is the shortage of knowledgeable individuals whose education, sophistication and personality make them successful private bankers. Adapting to the clients' changing expectations and tastes is also a major concern. The new breed of client not only wants expert advice and service but also wants to retain a tight grip. They want to be more directly involved and not just write a check. These clients need legal and financial advisers to not only assist with traditional tax problems, but to advise on nontraditional situations such as whether to take stock or cash during a buyout or whether to use derivatives to hedge against a fall in a stock's value.

Traditionally, clients learned of private banking services by word of mouth. As competition for these clients has increased however, financial institutions are using very specific marketing strategies such as seminars, advertising on web sites and in upscale magazines and even direct mailings to reach the market. Forming alliances with attorneys and CPA's is proving fruitful as are referral programs with affiliates and retail bankers.

Overview of Private Banking Products and Services

Private banking accounts may be opened in the name of an individual, a commercial business, a law firm, an investment advisor, a trust or a private investment company (PIC), among others.

Private banking products and services typically combine the wide array of commercial/retail banking services with services offered by the trust department. Some private banking products and services are described below.

Deposit Taking Activities

The private banking client's deposit account typically serves as the foundation of the relationship. It usually serves as the conduit for the client's money flow. The client's deposit account minimums and the fees assessed for retail banking services are generally much higher than those for a typical retail/commercial customer, as the private banking client will be provided a higher level of customer service.

Private banking often provides a broad range of deposit services that include check writing, deposit taking, withdrawals and wire transfers. A private banking customer may also need multi-currency deposit accounts if engaged in foreign securities and derivative trading activities involving foreign currency exchanges.

Credit Facilities/Activities

Private banking clients frequently request secured or unsecured credit to finance personal and business activities. Credit vehicles may include mortgages, lines of credit, letters-of-credit, bills-of-lading and credit cards.

Margin Loans

These types of loans are prominent in private banking operations. Margin loans are loans secured by margin stock. Margin stock encompasses equity securities, convertible debt or mutual funds that are registered or have unlisted trading privileges on a national securities exchange, or any OTC security designated as qualified for trading in the National Market System.

OTS chartered banks involved in margin lending are subject to registration and reporting requirements with the Federal Reserve and have certain lending restrictions. The Federal Reserve has opined that Regulation U applies to the activities of a bank/thrift when it is acting in its capacity as a trustee. If a savings association extends either $200,000 in margin loans in any calendar quarter or maintains credit outstanding in any calendar quarter totaling $500,000 or more, it must file Form FR G-1 with the Federal Reserve. For each credit secured by margin securities, the lender and the borrower must fill out Federal Reserve Form G-3 and the lender must maintain a collateral list for three years after the credit is paid off. The bank must file Federal Reserve Form FR G-4 at the end of each calendar year.

Funds Transfer

This service involves the transfer of funds from the private banking client to third parties, typically as part of bill-paying or investment services. Transfers are executed on the basis of client instructions.

Hold Mail

Private banking clients who elect to have financial statements and other documents maintained at the savings association rather than mailed to their personal residence may utilize a private bank's "Hold-Mail" or "No-Mail" services. These services should only be provided when an agreement is in place between the institution and the client that indicates the exact nature of the service and when the client will pick up the mail (at least annually). The "Hold-Mail"/"No-Mail" services may also include the delivery of the client's mail to some prearranged location.

Investment Management

Private banking typically provides both discretionary and nondiscretionary investment management services. In a discretionary situation, the RM, a portfolio manager from an affiliate or an investment officer of the savings association is assigned the task of managing the private banking client's portfolio. The RM, portfolio manager or trust investment officer buys and sells securities for the client based on established investment objectives that the client has established. For nondiscretionary accounts, the RM, portfolio manager or trust investment officer may render advice to the client or simply act in accordance with instructions received from the client or the client's third-party asset manager. At no time does he have discretionary authority over the client's investments.

Personal Trust and Estate Services

Trust and estate services may be an integral part of the private banking relationship. The savings association may serve as the executor or administrator of the client's estate or may be appointed by the client to act as trustee under a trust agreement or will for individual or charitable purposes. These relationships are often complex in nature and require special expertise to administer.

Custody Services

The saving association will also offer custodial services to private banking clients. These services may include securities safekeeping, as well as recordkeeping and accounting for the receipt and disbursement of dividends and interest. In a custodial relationship the client instructs the institution with respect to the assets held and the custodian follows those instructions. The actual ownership of the assets remains with the client.

Stock Options

Often the private banker is involved with tax planning with regards to the client's current compensation. This is especially true when the client has received large bonuses, awards or golden parachute payments as compensation. The private banker may be asked to lend advice or assistance regarding the tax treatment surrounding the exercise of stock options.

Web Sites

Savings associations are finding they have to invest heavily in technology to improve their administrative efficiency and provide private banking clients with new ways of receiving information. The client wants information quickly and accurately coupled with good, strong advice. A large segment of private banking clients want to use the internet to communicate with their bankers. Managing the blend of technology and old-fashioned personal service is probably one of the most important challenges private bankers face. The level of spending on information delivery through Internet services is not likely to decrease in the near term. Customers will start to shop around if private bankers do not provide the services they demand.

Payable Through Accounts

The payable through account, commonly referred to as "PTA," is a deposit account through which U.S. banking entities (payable-through banks) extend check-writing services to clients of a foreign bank. The foreign bank, the master account holder, opens a master checking account with a U.S. bank and uses this account to provide customer access to the U.S. banking system. The master account, maintained at the foreign bank, is divided into "subaccounts," each in the name of one of the foreign bank's customers, who may or may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks on, and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement is virtually unlimited.

Private Investment Companies (PIC) and Offshore Trusts

Private investment companies (PIC) and offshore trusts are often used by private banking to serve a client's global needs. These may be "shell" companies or trusts that are established in offshore jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands and Netherlands Antilles. They are used to hold the client's assets and to provide confidentiality.

Private banking most often includes the above described services but may include additional services not listed here. All services offered should be governed by written policies and procedures and a strong system of internal controls.

Private bankers must use sound judgment and prudent banking practices, especially when they are assisting clients in establishing offshore vehicles. Establishing and following comprehensive policies and procedures are essential to minimizing the risks inherent in private banking. For example, the institution should

document that it has appropriate know-your-customer policies and procedures. Private banking departments should obtain information on each client and emphasis should be placed on verifying the source of the client's wealth. Policies should indicate the types of clients that the institution will accept and establish the level of authority needed to accept clients.

Client demands are forcing institutions to recognize that they cannot provide the best possible service if they try to do everything themselves. An increasing number are entrusting selected services such as account administration, investment management, custody and transaction processing to outside service providers. This has been one of the most significant developments in the private banking business in recent years. The increasing investment sophistication and the cost of transaction processing and back-office systems can pose an enormous constraint to private banking activities, particularly at smaller institutions. Private bankers are becoming aware that they have to offer the best available products and services even though they may not be from in-house resources. Outsourcing enables them to offer a wider array of products and services without investing vast amounts of capital. Most institutions are finding that costs are increasingly coming under the microscope of top management.

Management's Responsibilities / Oversight

Senior management of the private banking operation must establish a sound risk management and control environment and establish goals and objectives. They must also provide active oversight and create an appropriate corporate culture. Risk assessments should be an ongoing process and a separate compliance function should be established.

The savings association's board of directors should review the policies and procedures established for private banking on a regular basis. These policies and procedures, at a minimum, should address: know your customer concerns; offering of credit; documentation and due diligence; omnibus and concentration accounts; trust and estate administration (including estate and financial planning if these services are being extended); and monitoring and reporting suspicious-activity.

The savings association must also provide for adequate risk management and monitoring systems. Sound private banking operations emphasize information relating to the clients and due diligence where needed to verify information provided by the client or the client's representative. Systems should provide management with timely information necessary to analyze and effectively manage the private banking business, monitor accounts for suspicious-activity and report such activity to authorities as required.

Sound risk management processes and strong internal controls are critical to private banking activities. Management's involvement in ensuring the integrity of these processes has become increasingly important as new products and activities are introduced. The quality of risk-management practices and internal controls should be given significant weight in the evaluation of management and the overall condition of private banking operations. An institution's failure to establish and maintain a risk management framework that identifies and controls the risks associated with private banking should be strongly criticized, especially if the private banking operations are extensive.

The private banking function is exposed to a number of risks, including reputational, fiduciary, credit, legal, operational and market risks. Although effective management of all risks is crucial, reputational risk may have the most profound effect on the bank and its private banking operations. There is a potential that negative publicity concerning the bank's business practices and clients could cause a runoff in the customer base or costly litigation resulting in a large revenue reduction.

An effective compliance program should be developed for ensuring compliance with laws and regulations. Some institutions may have a distinct compliance department for ensuring compliance institution-wide while others may have a separate compliance function within each business line, including private banking.

Private Banking Examination Program

Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's private banking activities. Consider whether:

- an effective system of policies, procedures and internal controls has been implemented;
- personnel are qualified to effectively administer private banking accounts;
- effective risk management, compliance and audit functions have been implemented; and
- management identifies deficiencies and promptly initiates corrective action.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to private banking activities. Scoping material should include:
   - Risk profile
   - Relevant PERK documents
   - Previous trust and asset management examination report
   - Workpapers from the previous examination
   - Previous safety and soundness examination report
   - Most recent ADV filed and any amendments

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

- Board of director and other committee minutes
- Examination reports of subordinate, functionally regulated entities

2. Assess the adequacy of policies and procedures, taking into consideration the range of services being offered to private banking clients and the method of aggregating client holdings and activities across business lines.

3. Ensure that the trust department has implemented appropriate "know your customer" policies and procedures. Do the policies and procedures consider:
   - the purpose and reasons for opening the account;
   - anticipated account activity;
   - source of wealth;
   - estimated net worth;
   - source of funds (description of the origin and the means of transfer for monies that are accepted for the account opening); and
   - references or other sources to corroborate reputation information where available.

4. Determine whether any new private banking products or services have been introduced. If so, were appropriate policies and procedures implemented?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

5. Are any of these products or services outsourced to third parties or affiliates? If so, are there written outsourcing agreements?

6. Evaluate how management monitors private banking activities. Assess the reports management regularly receives and determine if they are sufficient based on the level of complexity of these activities.

7. Evaluate whether management has the knowledge and expertise to manage its private banking activities. Note any significant personnel and/or organizational changes and discuss with management.

8. Are individuals with expertise managing the relationships, administering the private banking accounts and providing the appropriate products and services?

9. Review management practices regarding risk assessment, compliance and audit reviews of private banking products and services. Consider whether procedures are in place to cover all activities, products and services, including:

   - Depository activities
   - Credit related activities
   - Cash management/wire transfer activities
   - Hold mail services
   - Payable through account services
   - Investment management services

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

- Estate, tax or financial planning services
- Custodial services
- Trust and fiduciary services
- Insurance products
- Electronic commerce

10. Is there a requirement that all new clients and accounts are approved by at least one person other than the private banker?

11. Are there policies and procedures for updating the client file on a regular basis or when there are major changes?

12. Are there policies and procedures regarding the privacy of client information in accordance with OTS regulations, including the use of disclosures, where appropriate?

13. Consider whether the following risk contributors, if applicable, have been addressed:
    - Does management fully understand all aspects of risk with respect to private banking?
    - Are the monitoring systems sufficient to handle this line of business?
    - Does the board provide effective oversight?
    - Are outsourcing agreements comprehensive?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents, such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification.

1. Review the results of internal risk assessment, compliance and audit reports and assess compliance with policies and procedures. Discuss any unresolved issues or exceptions with management.

2. Do the number of clients or accounts assigned to relationship managers appear reasonable?

3. Does the fee structure reflect the services provided for private banking accounts? Are the fees reasonable compared with services offered?

4. If offered, does the savings association have adequate policies and procedures for tracking margin loans? Has someone been authorized to ensure Regulation U filings are current?

5. Does someone have responsibility for ensuring proper collateral is maintained on margin loans and for contacting the client when additional collateral is required?

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

6. Are proper procedures in place to ensure that all discretionary trust and asset management accounts receive proper investment reviews?

7. Does the private banker hold regular meetings with the client(s)? Is someone representing the various areas of expertise present at the meetings (i.e. banking, investments, trust, generational planning, insurance, etc.)?

8. If a company is a client, such as a private investment company, does the private banker understand the structure of the company sufficiently to determine the initial capitalization of the funds received, the principal owner(s) of shares or who has control over the funds?

9. If the private banker accepts walk-in clients or electronic banking relationships, determine if policies and procedures require a higher degree of due diligence prior to account acceptance.

10. Is management aware of the risks involved from accepting accounts from high-risk countries, offshore jurisdictions, clients whose wealth emanates from high risk activities, or from individuals who have or have had positions of public trust (i.e. politicians, government officials, important political party officials, etc.).

11. Is management aware of the legal environment as it pertains to private banking? Has management considered:

    - Graham-Leach-Bliley Act
    - State Principal and Income Act
    - 12 C.F.R.§§563.41 & 42

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

- Appropriate SEC & NASD Laws and Regulations
- The Economic Growth and Tax Relief Reconciliation Act of 2001
- State law version of the Uniform Trust Act

12. Is management sensitive to personnel issues such as commission based versus fee based compensation, licensing, product knowledge training, sales skills and employee supervision?

13. Are the savings association's accounting and tickler systems adequate to provide management with timely information regarding all areas of expertise necessary to effectively run a private banking division?

14. Are there written policies and procedures for identifying unusual or suspicious activities? Ensure that the policies include:

    - the definition of unusual or suspicious activities;
    - how to identify unusual or suspicious activities;
    - monitoring;
    - reporting;
    - follow-up, analysis and decision making concerning the activity;
    - record retention; and
    - education and training programs.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

15. Are there referral fees and/or revenue sharing arrangements? If so, does management regularly review these arrangements and is applicable law followed in regards to disclosure or other requirements?

16. Has management ensured that the role of audit and compliance is proactive versus reactive?

17. Has management entertained offering aggregation for its clients? If so, are the necessary risk and key controls (i.e. security, compliance, vendor management, data gathering and use, contracting, etc.) in place?

18. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of relationships for review. Assess whether adequate documentation exists to establish the identity of clients and beneficial owners.

2. Perform a detailed file review of depository activities. Consider whether:

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

- sufficient identification of clients is required;
- adequate due diligence is performed prior to acceptance of the relationship;
- adequate documentation exists on the establishment of accounts and their continued activities;
- account activities are monitored for potential illegal activities, such as money laundering; and
- appropriate investigation and reporting procedures are in place for suspicious activities.

3. Perform a review of credit activities. Consider whether:

- applications, disclosure, underwriting and other necessary documentation are maintained;
- underwriting supports the credit decision;
- collateral requirements are met for secured loans;
- appropriate controls are in place and repayment capacity is supported for unsecured loans;
- appropriate loan review and approval process is in place;
- for margin loans, appropriate collateral is obtained and regulatory compliance documented;
- appropriate collection procedures are in place; and
- appropriate loan loss reserves have been established.

4. Review fund transfer activities. Consider whether:

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp. Ref.

- proper authorization and approval documentation exists;
- the recipient has authorization to receive the funds;
- fund transfer activities are monitored to detect unauthorized or illegal activities; and
- appropriate reporting procedures are in place to detect suspicious activities.

5. Review hold mail activities. Consider whether:

   - adequate contracts are established that specify the date the hold mail is to begin and end, the dates the hold mail is to be forwarded and the location for delivery;
   - appropriate identification procedures are required for hold mail pickups; and
   - items received are reviewed, itemized and held under dual control.

6. Review payable through accounts. Consider whether:

   - similar due diligence efforts are performed for both international and domestic clients;
   - evidence exists that accounts are being continually monitored for money laundering and other illicit activities;
   - adequate information is obtained and verified about the ultimate users of these accounts. If the information is not obtainable, is the account closed?
   - sufficient records and transaction histories are maintained for omnibus or general clearing accounts.

7. Review private investment companies, offshore and token name accounts. Consider whether:

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

- management is familiar with these accounts and the account holders;
- adequate documentation exists with respect to related parties; and
- the accounts are monitored for suspicious activities.

8. Review the suspicious activity reports (SARs) filed during the review period. If any involve private banking clients, discuss the resolution with management.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 740P

Laws

Graham-Leach-Bliley Act
SEC Rules
State Insurance Laws

Code of Federal Regulations

12 CFR 550	Trust Powers of Federal Associations (General)

Office of Thrift Supervision Publications

OTS Memorandum	Enhanced Scrutiny for Transactions That May Involve The Proceeds of Foreign Official Corruption, January 31, 2001
OTS Thrift Bulletin TB11-1	Purchased Software Evaluation Guidelines, April 20, 1989
FHLBB Resolution 86-277	Exercise of Trust Powers
FFIEC Publication	Risk Management of Outsourced Technology Services, November 28, 2000

Board of Governors, Federal Reserve System
SR 97-19, Private Banking Activities, June 30, 1997
Guidance on Sound Risk Management Practices Governing Private Banking Activities, July 1997
FRB Rule 23 A & B
FRB Reg U

Other

Wolfberg AML Principles,	Global Anti-Money-Laundering Guidelines for Private Banking, October 30, 2000

OCC Bulletin 2001-12, Bank-Provided Account Aggregation Services, February 28, 2001

Workpaper Attachments - 740P

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process. For additional guidance, the examiner should also reference the private banking examination program questions and all other pertinent optional topic questions contained within this handbook.

Know Your Customer

• Do the saving association's policies and procedures take into account the following components? • Obtaining identification and basic background information on the clients? • Describing the client's source of wealth and line of business? • Requesting references? • Handling referrals? • Identifying red-flags or suspicious transactions? • Corroborating the client's source of wealth? • The date of the information?
• Do the policies and procedures require that the type and volume of transactions expected to be passing through the account are compared with actual flows?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Introduction to Corporate Trust

Corporate trust and agency services are normally performed by a trust department in connection with the issuance, transfer or redemption of securities, pursuant to an agreement between the department and the issuer (usually a corporation or state or local governmental body). It is not uncommon for a single trust agreement (indenture) to be the creating instrument for both the corporate trust and related corporate agencies. Performance as ***Trustee Under a Bond Indenture*** is normally the only true trust relationship administered by a corporate trust department. Under the indenture, there is only one trustee for a given bond issue but several agents or coagents may be created to serve the same issue. The most common corporate agency activities include: stock transfer agent, registrar for stock or bond issues, paying agent for bond interest or stock dividends, dividend reinvestment agent or depository. This section focuses on institutions acting as trustee for bond issues, the relationship most commonly found in the corporate trust area of a savings association.

Financial institutions serve in a dual capacity when administering many of the corporate trust relationships that have evolved over the years. They have responsibilities to both the party issuing the securities under the provisions of the indenture and to the individuals and institutions that have purchased the securities. The trustee's primary responsibility, however, is to act at all times on behalf of, and for the protection of, securityholders.

The party that hires the institution and pays the account administration fees is typically the issuer of the securities. The institution, as trustee or agent, is ordinarily responsible to the issuer for such functions as: investing funds on deposit (such as construction funds or monies deposited for future bond payments); maintaining bondholder records; preparing accountings; effecting transactions; and other ministerial activities. At the same time, one of the primary reasons for the creation of the trust indenture and appointment of a corporate trustee (which must be independent from the issuer) is the protection of the securityholders (bondholders, stockholders, etc.). To provide this protection, the trustee must ensure that the issuer complies with all the provisions of the indenture agreement. This is accomplished through such steps as: the timely collection and payment of interest and principal; the perfection and maintenance of the institution's clear title to any collateral; the filing of tax information; the monitoring of indenture default provisions; and other specified duties.

Corporate agency services are provided by a department in connection with both equity and debt securities. These services may or may not be performed in conjunction with corporate trustee services.

Corporate Trust Accounts

As with other types of accounts, the corporate trustee's specific duties and responsibilities are contained in the governing instrument, called an indenture. Among the more important duties that should be addressed in the indenture are those relating to:

- ensuring compliance with the terms of the indenture agreement;
- arranging for the printing and issuance of the securities;
- paying principal (bond redemption and maturity) and interest;
- funding instructions for specialized funds (e.g., depreciation or reserve funds);

- maintaining specific funds required by indenture (i.e., sinking, construction funds, etc.);
- maintaining insurance coverage;
- reports required (to issuer and bondholders);
- holding beneficial title to collateral (if any);
- safeguarding and appraising collateral;
- use of the funds for the payment of the issuer's obligations (including the temporary investment of those funds and their allocation to specific accounts);
- monitoring for default under the indenture during the life of the bonds; and
- identifying and reacting properly if a default occurs.

The administration of corporate trust accounts and agencies generally does not require that the trustee/agent exercise as many discretionary decisions and actions as other types of relationships. Nevertheless, proper administration does require that a higher level of documentation and recordkeeping sophistication be maintained and that department personnel possess a detailed knowledge of securities and securities-related functions. The trustee must also exercise caution that it does not have any conflicts of interest that would prevent it from acting with undivided loyalty.

Proper administration of underlying collateral is vital, including identification and control of environmental risk where real property is concerned. While the courts have not held a trustee liable for environmental hazards that it did not create or contribute to during the trusteeship, caution must still be exercised by the trustee concerning potential environmental hazards. Extreme care must be taken by the trustee regarding the timing of collateral foreclosure so that the interests of all parties to the indenture are fairly served. It is important to realize that a trustee's failure to perform properly in protecting the bondholders before, during and after a default, can result in liability and loss to the trustee that frequently is not assessed by the courts until years later. Proper maintenance of the collateral, including periodic verification or continuance of Uniform Commercial Code (UCC) filings, is required. Should the trustee prematurely foreclose on collateral, the obligor may incur liability. If foreclosure is inordinately delayed, bondholder interests may suffer severe loss of value.

Many bond trusteeships involve the maintenance of separate funds to be used for such things as sinking funds, construction monies and building maintenance expenses. The assets of these funds are invested according to the provisions of the bond indenture. The institutional trustee usually has minimal discretion over such investments. Proper separation and administration of the various funds is required and proper investment of the assets is essential.

The trustee must not only provide reports and recordkeeping for the obligor but must also protect the interests of the bondholders. Reporting of distributions, interest and dividend payments to both tax authorities and security holders is required of the trustee.

Many bond issues have become exceedingly complex, imposing a host of additional duties on trustees. For instance, credit enhancements such as letters of credit and municipal bond insurance may have their own requirements for the trustee. Interest rates may be indexed to other indices. Derivative issues have also become common. These kinds of bond issues have imposed new types of risks for trustees. Trustees must have sufficient knowledge to be aware of their responsibilities and adequate policies and procedures in place to manage the risks to the bondholders.

The trustee must also exercise prudent judgment to identify and control any conflicts of interest that would prevent it from acting with perceived or actual undivided loyalty. For bond issues subject to the Trust Indenture Act of 1939, prohibited conflicts must be identified in the indenture. Section 310(b) of the Trust Indenture Act (15 U.S.C. Section 77jjj(b)) establishes procedures for the disqualification of the indenture trustee in certain instances involving the trustee's conflict of interest in certain situations. Section 311 of the Act (15 U.S.C. Section 77kkk) provides procedures with respect to situations in which the indenture trustee has a creditor interest in the indenture securities. For bond issues not covered by the Trust Indenture Act of 1939, the question of conflicts of interest is still of importance and trustees have been held liable where it was felt they acted other than in the best interest of the bondholders.

A potentially high-risk situation for an institution is where it is both a corporate trustee and a creditor of the obligor. In this instance, if an obligor becomes insolvent and a default occurs under an indenture, the question arises whether the institution can simultaneously serve its stockholders and the issue's bondholders. By attempting to improve the institution's credit position or chances of repayment it may fail in its responsibility to protect the interests of all bondholders. A similar situation may be encountered where the institution acts as trustee for more than one debt issue (senior vs. subordinate or secured vs. unsecured) of an issuer. These kinds of conflicts are permissible for issues subject to the Trust Indenture Act of 1939 so long as the issue is not in default. However, once a default occurs, and unless the default is cured within the ninety-day period set in Section 310(b) of the Trust Indenture Act, the trustee is required to resign.

These potentially conflicting relationships should be identified and resolved prior to account acceptance and reviewed during the life of the bond issue. Some institutions make prior arrangements to resign in favor of another trustee in the event of default. Often, the successor trustee requires indemnification for the original trustee's acts.

Trust Indenture Act of 1939 and Trust Indenture Reform Act of 1990

The Trust Indenture Act of 1939, as amended by The Trust Indenture Reform Act of 1990 (TIA), was adopted (in part) to protect bondholders from breaches of fiduciary duty by trustees, to provide a mechanism to enable bondholders to unite for the protection of their interests, to assure bondholders that they will be served by a disinterested and responsible trustee and to establish minimum standards of responsibility and accountability for trustees and obligors.

Below is a summary of the more significant provisions of the TIA. However, due to its complexity and the limitations of space, the TIA itself should be consulted for more detailed explanations, and for exceptions and limitations to particular rules.

- Certain types of securities cannot be offered or sold to the public unless they are "qualified" by the SEC.
- The TIA is applicable to indentures that provide for a total issuance in excess of $10 million in principal value (with certain exceptions such as U.S. Government and agency securities and municipal bonds).
- A financial institution must be appointed as trustee for the bondholders.
- If a default occurs, a conflicting interest will "disqualify" a trustee (make it ineligible to be an indenture trustee) or require it to resign, unless the conflicting interest is eliminated.
- A number of situations are specified that will constitute a conflicting interest. Basically, they involve relationships of the trustee with either an obligor or an underwriter. The relationships include (all with

exceptions and rules of special application) acting as trustee under more than one indenture of the same obligor, being under the direct or indirect control of an obligor, having common directors with an obligor, owning more than a specified percentage of stock of the obligor by the trustee or vice versa and other similar relationships.

- Certain financial statements and reports must be filed by the obligor and given to the trustee, who in turn, notifies the bondholders. The trustee must also keep a list of all bondholders and notify them if any changes in its relationship with the obligor have occurred.
- The TIA spells out duties and responsibilities prior to, during and after default. For example, one of the duties in the event of a default is to act in accordance with the prudent man standard.

Corporate Agency Accounts

Some of the most common types of corporate agency services provided are: stock transfer, stock registrar, mutual fund transfer, fiscal or paying agent, dividend disbursement, escrow, conversion, exchange and/or subscription.

Stock Transfer Agent

Stock transfer agents usually perform three functions. First, they act on behalf of the issuer of securities to countersign the securities and monitor issuance (e.g., original issues, stock dividends, splits) to prevent unauthorized issuance. Second, they maintain records of who owns the shares of stock, how many shares are owned and which certificates are owned. Third, they perform the functions of cancellation and re-issuance of certificates to reflect changes in ownership.

In connection with the latter, certificates submitted are checked for authenticity and appropriateness of accompanying documents, canceled and replaced by the issuance of new certificates. The transfer agent sends the canceled certificates and corresponding newly issued certificates to the registrar for verification. This involves only an in-house transmittal when the institution acts both as transfer agent and registrar. After registration, the newly issued certificates are sent to the registered owners or their representatives and appropriate disposition (destruction, return of canceled certificates to the issuer or cancellation and retention in a controlled area) is made of the canceled certificates. The securities industry is relying increasingly on “book-entry only” securities whereby no physical securities are delivered to the owners but ownership is represented by bookkeeping entries in the owners’ brokerage account. Master or “jumbo” certificates representing the entire outstanding bond issue are maintained at a depository.

A bank can either be a registered or a nonregistered transfer agent. Whether or not a transfer agent needs to be registered is governed by Section 17A of the Securities Exchange Act of 1934, which also addresses reporting, recordkeeping and timing for transfer agent activities.

Stock Registrar

As registrar, an institution performs the critical duty of guarding against over or under issuance of the security, which is sometimes referred to as an out-of-proof or out-of-balance condition. In addition to checking original issues, the registrar checks each transfer made by the transfer agent for genuineness of the certificates presented for transfer, cancellation of the old certificates and that the number of shares represented by the new certificates does not exceed the number of shares represented by the old (canceled) certificates. In the case of bonds, the indenture trustee normally performs this function. New York Stock

Exchange rules permit one institution to act as both transfer agent and registrar for listed securities other than its own.

While unusual, financial institutions are sometimes appointed only registrar of a stock issue without the more typical dual appointment of transfer agent as well.

Mutual Fund Transfer Agent

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

Two characteristics of mutual fund transfer operations are very different from stock or bond transfer operations. Mutual funds normally do not issue certificates to evidence ownership. Instead, entries on the books of the mutual fund or its transfer agent identify the owners and record the number of shares owned. In addition, open-end mutual funds do not have a limit on the number of outstanding shares. Therefore, the "registrar function" handles an ever increasing and decreasing number of shares outstanding, depending upon subscriptions and redemptions.

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

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

Paying or Fiscal Agent

When the trust department is serving as paying or fiscal agent for corporations and municipalities, the obligor deposits the necessary payment amount with the thrift. The trust department then prepares and issues checks, credits established accounts or wires funds for the payment of interest, dividends or redeemed or matured bonds. For bearer bonds, payment is made upon presentation of coupons. In the case of registered bonds, payment is sent to the owner of record.

Dividend Disbursing Agent

The functions of a dividend disbursing agent are similar to those performed by paying agents, in that a trust department will forward dividends on equity issues directly to the shareholder of record. Closely related to this function is that of serving as dividend reinvestment agent, where dividends are paid by the dividend disbursing agent to the reinvestment agent (often the same institution) to be used to purchase additional shares of the corporation.

Corporate Trust Examination Program

Examination Objectives

To determine the adequacy and effectiveness of the trust department's administration of corporate trust accounts. Consider whether:

- effective policies, procedures and internal controls have been established;
- there is sufficient management and staff expertise to administer these accounts;
- the legitimate needs of security holders and other interested parties are met in a professional and timely manner;
- policies and procedures ensure compliance with governing instruments, applicable law and accepted fiduciary principles; and
- deficiencies are identified and corrective action promptly initiated.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to corporate trust accounts. Scoping material should include:
   - Risk profile
   - Pertinent PERK documents
   - Previous trust and asset management examination report
   - Workpapers from the previous examination

Exam Date: ____________________
Prepared By: ____________________
Reviewed By: ____________________
Docket #: ____________________

Wkp. Ref.

- Examination reports of subordinate, functionally regulated entities
- Board of director and other applicable committee minutes

2. Determine the account types and volumes of accounts currently being administered. Identify any changes in product and service offerings since the previous examination. If applicable, determine that necessary approvals, notifications or registrations have been filed.

3. Determine whether management and staff have the expertise to effectively manage corporate trust accounts.

4. Review policies, procedures and practices related to the administration of corporate trust accounts. Identify any significant changes since the last examination. Determine their adequacy relating to:
   - acceptance of accounts;
   - administration of accounts;
   - termination of accounts;
   - conflicts of interest;
   - monitoring for instances of default; and
   - compliance with escheat laws.

5. Review internal risk management, audit and compliance programs for adequate coverage of corporate trust activities.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

6. Consider whether the following risk contributors have been addressed:

   - Does management fully understand all aspects of risk associated with corporate trust accounts?
   - Has the board implemented appropriate policies, procedures, practices and internal controls covering all facets of account administration?
   - Have comprehensive and effective audit, compliance and risk management processes been established?
   - Does management exhibit familiarity with applicable law and accepted fiduciary principles?
   - Are appropriate management reporting systems in place?
   - Does the trust department exhibit consistency in account administrative practices?
   - Are standards in place governing account documentation?
   - Are there material unresolved corporate trust account issues noted in audit, compliance or examination reports?

The completion of Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents, such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

1. Review the trust department's account set-up procedures and practices. Consider whether:

   - all appropriate documentation is obtained and reviewed;
   - accurate synoptic information is assembled and maintained; and
   - necessary tickler systems are in place.

2. Review procedures for processing interest and dividend payments, lost securities, maturities, early redemptions, splits and dividend reinvestments. Confirm compliance with SEC standards for control, turnaround, documentation and reporting.

3. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, discuss corrective action with management.

4. Review controls over dormant accounts or unclaimed funds. Consider whether:

   - appropriate controls are in place;
   - funds are segregated and periodically reconciled; and
   - proper disposition of funds has been made either through return to the obligor or escheatment to the appropriate state authority.

5. Determine if procedures address the filing of necessary approvals, notifications or registrations.

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

6. Ensure that there are procedures for determining the status of alleged lost, missing or stolen securities, e.g. proper notification procedures with the Securities Information Center (SIC).

7. Determine if there have been any losses from improper or untimely reporting of tax information.

8. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I and Level II procedures, or data contained in department records or internal or external audit reports, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of the Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Select a sample of bond trustee accounts. Review the account files to determine compliance with applicable law or accepted fiduciary standards, as well as internal policy and procedure. Confirm that the trust department is complying with the terms of the trust indenture.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

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2. Select a sample of corporate agency accounts. Review the files to determine compliance with applicable law or accepted fiduciary standards, as well as internal policy and procedure. Confirm that the trust department is complying with the terms of the governing instrument.

______________________________ ______

3. Select a sample of mortgage-backed pass-through securities accounts. Review the files to determine compliance with applicable law or accepted fiduciary standards, as well as internal policy and procedure. Confirm that the trust department is complying with the terms of the governing instrument.

______________________________ ______

4. Review successor appointments to determine whether acts of prior fiduciaries are reviewed, assets are properly received and other appropriate documentation is obtained.

______________________________ ______

5. Identify all bond trustee accounts where instances of default have occurred. Determine that appropriate actions have been initiated according to the governing instruments.

______________________________ ______

6. Verify the accuracy of audit, compliance and risk management report findings.

______________________________ ______

7. Review and verify the accuracy of any applicable management exception reports.

______________________________ ______

Exam Date: ______________
Prepared By: ______________
Reviewed By: ______________
Docket #: ______________

Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 750P

Laws

Trust Indenture Act of 1939
Trust Indenture Reform Act of 1990

Code of Federal Regulations

12 CFR 550	Trust Powers of Federal Associations (General)
12 CFR 550.410	Recordkeeping

Office of Thrift Supervision Publications

Other

UCC	Article 9

Workpaper Attachments - 750P

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Acceptance of Accounts

- Has all necessary documentation been obtained and reviewed?
- Are the duties and requirements of the trustee identified?
- If necessary, has a legal opinion regarding the indenture been obtained?
- Has the ability of the trust department to perform its responsibilities been assessed?
- Has the likely repayment capacity of the issuer/obligor been analyzed?
- Has the relationship been reviewed for conflicts of interest?
- Has the integrity of the issuer/obligor been assessed?
- For real estate collateral, have any environmental issues been addressed?
- Has the profitability of the account been considered?
- Has the account been approved by the appropriate committee/individual as per policy?

Account Set-up Procedures

- Has the following documentation been obtained:
  - Original or certified copy of the trust indenture, including any amendments or supplements?
  - Evidence of recordkeeping, as required by state or local law?
  - Certificate of incorporation of the issuer?
  - Authorizing corporate resolution by the board of the issuer?
  - Opinion of counsel supporting the legality of the issue, if deemed necessary?
  - Authorization of stockholders, court officials, creditors or other bondholders, as necessary?
  - Specimen signatures of authorized corporate personnel of the issuer?
  - Approvals of any regulatory authorities, as necessary?
  - Identification and authentication of all collateral?
  - Evidence of title to the collateral or documentation that the appropriate lien position has been recorded in accordance with state or local law?
  - Evidence that appropriate insurance of collateral is in place?
  - Any other necessary documentation as indicated by the trust indenture?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

• Evidence that the above documentation was reviewed and approved for acceptance by the appropriate committee?

Annual and Administrative Reviews

• Is synoptic information confirmed to be accurate?
• Are tickler systems functioning properly?
• Are all administrative duties performed in accordance with the terms of the indenture?
• Have instances of default been appropriately identified and addressed?
• Have conflicts of interest been appropriately identified and addressed?
• Are accurate records on security certificates (blank, unissued, issued, outstanding, returned, destroyed) properly maintained?
• Are reviews performed in a timely manner, in accordance with regulation and internal policy?
• Have timely payments of principal and interest been made?
• Are payments to any special funds created under the instrument, such as sinking funds being made?
• Are only authorized investments being utilized?
• Has appropriate documentation and authorization been maintained for the receipt, retention or release of collateral?
• Is adequate insurance in force?
• Are the receipt and review of obligor's annual financial statements, annual reports or other documentation performed and documented?
• Are real estate, or other applicable property or tangibles, tax payments current?
• Have completion certificates been received?
• Have annual officer affidavits been received?
• Has documentation supporting construction advances been obtained?
• Are appropriate reserves being maintained?

Successor Appointments

• Is proof obtained of the prior trustee's removal or resignation?
• Are original or certified copies of governing instruments obtained?
• Does the department verify that all governing documents and essential supporting documentation has been received?
• Do department personnel obtain and review accountings by prior trustee(s)?
• Is a reconciliation perform to ensure that all assets, as well as income thereon, have been received?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

• Does the trust department obtain indemnification from the prior trustee?

Mortgage-backed Pass-through Securities

• If the trust department acts as trustee or agent for mortgage-backed pass-through securities, are any of the pools privately insured?
• Is the insurer in sound financial condition and appropriately licensed?
• Is the amount of the insurance adequate to satisfy the loan if the underlying mortgage goes into default?
• Is the trust department in compliance with the duties and responsibilities described in the governing instrument?
• Do the trust department or qualified outside parties review the adequacy of loan documentation?
• Does the trust department review appraisals of the underlying properties to verify that such appraisals have been conducted and are adequate?
• Are there any conflicting relationships with the mortgage banker and, if so, are the savings association's policies and procedures sufficient to protect itself in the event of default of the debt?

Exam Date: ____________________
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Docket #: ____________________