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]

[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.