

This document and any attachments are superseded by  
Comptroller's Handbook - Conflicts of Interest.

## 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.<sup>1</sup>

Savings associations should understand and follow all the state and federal laws governing the investment of fiduciary account assets in mutual funds.<sup>2</sup> 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

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

<sup>2</sup> 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 in which it has investment discretion. See 12 CFR §550.220.

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# Conflicts of Interest Examination Program

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## 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.

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## 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

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

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- 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

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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.

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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.

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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.

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

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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

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**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.**

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### 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.

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

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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.

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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.

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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.
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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.
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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.
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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.

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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.

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**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.

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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.

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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.

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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.
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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.

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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.

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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.

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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.

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

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#### 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

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## 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***

<ul style="list-style-type: none"><li>• Does the policy establish standards of business ethics?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy define a conflict of interest?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy set forth procedures for screening transactions to determine the existence of conflicts and provide a system of compliance?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy address trust department employees serving as a cofiduciary?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy address loans to fiduciary clients?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy address trust department employees accepting gifts and bequests from fiduciary clients?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy prevent employees from unauthorized trading?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy prohibit personal trading based on information gained as an employee of the savings association?</li></ul>
<ul style="list-style-type: none"><li>• Are procedures in place for the reporting of personal securities transactions?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy define material inside information?</li></ul>
<ul style="list-style-type: none"><li>• Does the policy suspend trading activity in affected securities until such information is made public?</li></ul>
<ul style="list-style-type: none"><li>• Are procedures in place to prohibit front running?</li></ul>

### ***Own-bank Products and Services***

<ul style="list-style-type: none"><li>• For own-institution deposits:<ul style="list-style-type: none"><li>• Is the investment allowable under local law and authorized by the governing instrument?</li><li>• Are rates and services comparable to competing financial institutions?</li></ul></li></ul>
<ul style="list-style-type: none"><li>• For proprietary mutual funds:<ul style="list-style-type: none"><li>• Is the investment allowable under applicable law?</li><li>• Are appropriate disclosure procedures in place?</li><li>• Has documentation been made that this is a prudent investment?</li></ul></li></ul>
<ul style="list-style-type: none"><li>• For own-institution or affiliate securities:<ul style="list-style-type: none"><li>• Is the investment permitted under applicable law?</li><li>• Has documentation been made that this is a prudent investment?</li><li>• Are appropriate disclosure procedures in place?</li></ul></li></ul>

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<ul style="list-style-type: none"> <li>• Are appropriate procedures in place governing the proxy voting of such securities?</li> </ul>
<ul style="list-style-type: none"> <li>• For affiliated brokerage, insurance or other services:             <ul style="list-style-type: none"> <li>• Does applicable law permit the use of these products and services?</li> <li>• Were proper disclosures made to the appropriate account holders?</li> </ul> </li> </ul>

### ***Transactions With Accounts***

Are policies and procedures in place governing:
<ul style="list-style-type: none"> <li>• The sale of assets to itself from an account for which the savings association is a fiduciary?</li> </ul>
<ul style="list-style-type: none"> <li>• The making of a loan to an account that is secured by an interest in the assets of the account?</li> </ul>
<ul style="list-style-type: none"> <li>• The making of loans between fiduciary accounts?</li> </ul>
<ul style="list-style-type: none"> <li>• The sale of assets between fiduciary accounts?</li> </ul>

### ***Entities that savings associations may have an interest in***

Information on entities in which the savings association has an interest should include:
<ul style="list-style-type: none"> <li>• Names of directors and principal officers and their outside business affiliations.</li> </ul>
<ul style="list-style-type: none"> <li>• Names of affiliates, their directors and principal officers.</li> </ul>
<ul style="list-style-type: none"> <li>• 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.</li> </ul>
<ul style="list-style-type: none"> <li>• Names of principal shareholders (5 percent and over) of the savings association and its affiliates, excluding directors and principal officers.</li> </ul>
<ul style="list-style-type: none"> <li>• The institution's large commercial customers.</li> </ul>
<ul style="list-style-type: none"> <li>• 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.</li> </ul>
<ul style="list-style-type: none"> <li>• 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.</li> </ul>
<ul style="list-style-type: none"> <li>• 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.</li> </ul>

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