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Office of Thrift Supervision
Department of the Treasury

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**Thrift Bulletin**

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This document and any attachments are superseded by Comptroller's Handbook - Conflicts of Interest.

**Handbook: Trust Activities** **Section: 700**
**Subject: Conflicts of Interest**

## Conflicts of Interest Related to Fiduciary Accounts

***Summary:*** This bulletin provides guidance on how a savings association, in accordance with its duties of prudence and loyalty to fiduciary accounts, should manage conflicts of interest when it has investment discretion. Specific guidance is given with respect to the decision to use mutual funds as an investment vehicle when the savings association receives compensation or other benefits from the mutual funds.

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### General Guidance on Conflicts of Interest

A savings association providing trust and asset management services to fiduciary accounts may face a variety of conflict of interest situations. OTS is issuing this thrift bulletin to guide savings associations in identifying and managing these conflicts of interest. Conflicts of interest generally occur due to the inherent tension between the savings association's own interests and the interests of its fiduciary customers. As a fiduciary, a savings association has two primary duties: loyalty and prudence. As a fiduciary in accordance with its duty of loyalty, a savings association must always place the interests of its fiduciary customers first. The duty of loyalty entails making decisions concerning the investment and management of trust assets based exclusively on the best interests of the trust account. When a savings association acts in a fiduciary capacity it should not place itself in a position in which its interests (or those of its subsidiaries or affiliates) do or might conflict with the interests of the trust account. When a savings association utilizes, on behalf of fiduciary accounts for which it has investment discretion, its products or services or those of its subsidiaries or affiliates, the savings association faces a conflict of interest.

A savings association also has a duty of prudence in regards to its fiduciary accounts for which it has investment discretion. The duty of loyalty is separate and apart from the duty of prudence. 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 basis. In an increasing number of states, the prudent man rule has evolved into the "prudent

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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 event, 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 and/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 Funds Investments

More and more savings associations are receiving financial compensation or incentives from mutual funds. The mutual fund may (directly or indirectly) pay compensation to a savings association for investment advisory or other services rendered to the mutual fund. The mutual fund may also pay compensation to the savings association that is tied to how much money 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 from services rendered to the mutual funds as well as indirect financial benefits as a result of the increased volume of investments in those mutual funds.

The decision by the savings association to invest discretionary fiduciary assets in these mutual funds presents conflicts of interest to the savings association as a result of the direct and indirect financial benefits it receives. Most states have enacted legislation allowing savings associations to invest fiduciary account assets in proprietary mutual funds or non-affiliated mutual funds for which the savings association receives financial benefits from the mutual fund. Such state laws often address the fees that may be charged to the fiduciary account as a result of the mutual fund investment and/or the fees that may be received by the savings association as a result of the investment. State laws may address the type of disclosure that must be given to beneficiaries of the fiduciary account and may, in some cases, require consent from certain beneficiaries before such an investment may proceed.

Even if the applicable state law does not address disclosure of the nature of the conflict and/or the benefits the savings association is receiving as a result of the transaction, good risk management practices dictate that such disclosure should take place. A savings association should inform affected account beneficiaries, before any conflict of interest transactions take place, of the nature of the conflict and the financial benefits the savings association is receiving as a result of the transaction.[1]

Savings associations should be fully aware of and follow all the applicable state and federal laws involved governing the investment of fiduciary account assets in mutual funds.[2] The savings association should have well developed policies and procedures that address how the institution will meet all the requirements of applicable law. The savings association should also develop a risk assessment process that will determine on a regular basis whether the institution is in fact operating in accordance with its established policies and procedures.

In documenting its initial determination that a mutual fund investment meets the applicable state prudent man/prudent investor rules, the savings association should describe the benefits derived from the investment for both itself and the fiduciary account. The savings association should include in its prudent investment analysis such factors as historical investment performance in relation to similar mutual funds, expense ratio comparisons in relation to similar mutual funds, ratings of services such as Morningstar, familiarity with the mutual fund portfolio and investment manager, generation of capital gains and losses within the fund, and any other relevant factors, always taking into account the class of shares in which the fiduciary account is invested.

A savings association should regularly document its decision making process concerning the retention of mutual fund investments for fiduciary accounts. The documentation should include evidence that the investment is, and continues to be, appropriate for the individual account. The documentation should also discuss all the relevant prudence factors, any changes in the investment performance of the mutual fund, changes in fees and/or costs charged by the mutual fund, changes in the trust account or the trust beneficiaries, and changes in the economy or overall market condition.

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[1] The term “affected account beneficiaries” is defined for purposes of this thrift bulletin only 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.

The savings association may conduct this review of the suitability of mutual funds as investments for fiduciary accounts in conjunction with the annual review the savings association must perform for all fiduciary accounts in which the savings association has investment discretion. See 12 C.F.R. §550.220.

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