

RESCINDED

BC - 233

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Outdated - See OCC Bulletin 2015-3

Type: Banking Circular

Subject: Acceptance of Financial Benefits by
Bank Trust Departments

TO: Chief Executive Officers of National Banks Authorized to Exercise Fiduciary Powers,
Deputy Comptrollers (District), and Examining Personnel

PURPOSE

This issuance is intended to remind national banks of laws prohibiting bank trust departments from receiving any financial benefits, including discounts or rebates on goods or services purchased, or other items of value, in exchange for investing trust funds in particular investments.

BACKGROUND

It has come to the OCC's attention that a number of national bank trust departments may have accepted financial incentives from investment management firms that sponsor mutual funds or other investment funds in exchange for the investment of fiduciary assets in specific funds offered by those firms. These financial incentives appear to have taken the form of (i) discounts or rebates on fees paid for other products or services purchased by these banks from those same firms or from a third party pursuant to an agreement with the investment management firm, (ii) computer goods or services, or (iii) seminars and travel expenses for bank personnel in connection with programs offered or sponsored by investment fund sponsors. In some cases, these financial incentives have been provided pursuant to verbal agreements or understandings.

FIDUCIARY DUTIES OF BANK TRUST DEPARTMENTS

National bank trustees owe exacting fiduciary duties to customers who place trust funds under the bank's management. Trustees are obliged to make decisions concerning the investment of trust assets based exclusively on the best interests of trust customers. This principle is reflected in 12 C.F.R. § 9.12(a), which provides:

Unless lawfully authorized by the instrument creating the relationship, or by court order or by local law, funds held by a national bank as fiduciary shall not be invested in stock or obligations of, or property acquired from... individuals... or organizations in which there exists such an interest, as might affect the exercise of the best judgment of the bank in acquiring the property....

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A majority of the states have adopted this principle as a matter of fiduciary law. See 2A W.F. Fratcher, Scott on Trusts, § 170, Duty of Loyalty (4th ed. 1987). Many states have adopted statutes that expressly prohibit self-dealing by fiduciaries. Id. See, e.g., Cal. Prob. Code § 16004; N.Y. Est. Powers & Trust Law § 11-2.2; 7 Pa. Cons. Stat. §§ 403, 405.

The OCC has provided specific guidance in past issuances on the applicability of these principles to bank trust department relationships with investment companies. In Banking Circular 219 (October 31, 1986), the OCC warned national banks that the receipt of supplemental fees for placing fiduciary assets in 12b-1 funds was subject to 12 C.F.R. § 9.12(a). Because the receipt of 12b-1 fees creates a strong incentive for banks to continue investing in a particular fund over other alternatives, such fees are prohibited by Section 9.12, unless, in the case of non-ERISA accounts, specific lawful authority exists for the practice. Reference should be made to Banking Circular 219 (October 31, 1986) for additional guidance on the subject.

The acceptance by a national bank trustee of any financial benefits directly or indirectly conditioned on the investment of trust assets in a particular investment is prohibited under 12 C.F.R. § 9.12(a), and also is prohibited under the fiduciary laws of most states. When selecting a mutual or money market investment, a trustee should evaluate the return being paid, the composition and length of maturities of its portfolio, the fund's management and all other factors relevant to the suitability of the investment for the customers. Trustees must not place themselves in a position where their judgments concerning the optimal investment for trust accounts may be influenced by the trustees' receipt of financial benefits for selecting a particular investment.

The same principles apply whether banks receive (i) rebates or discounts on services provided by or at the direction of an investment management firm (such as accounting and administrative services), (ii) computer goods or services, (iii) seminars and travel expenses which are offered by, or at the direction of, such firms, or (iv) any, other financial benefits in exchange for investing trust funds in particular money market or mutual funds. Those principles also are applicable whether the financial benefits are received directly from the provider or indirectly through third parties. See OCC Handbook for National Trust Examiners, Precedents and Opinions 9.3115: G. Bogert, Trusts, 341-342 (6th ed. 1987); Restatement (Second) of Trusts Section 170(o) (1974).

When a national bank receives a financial benefit that is calculated based on the amount of trust funds invested with the provider of those products, the bank has a financial interest which

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interferes with its ability to select investments based solely on the best interests of trust beneficiaries. Unless financial benefits received in this manner are passed on to all beneficiaries according to the level of their investment in a fund, or are lawfully authorized by the instrument creating the relationship, by court order or by local law, the receipt of rebates, credits, services or other financial benefits is contrary to Section 9.12 and a bank's common law fiduciary duties. Further, national bank trust departments should be aware that the acceptance of financial incentives in the manner described above is not protected by Securities Exchange Act Section 28(e). Section 28(e) merely provides a statutory "safe harbor" for certain "soft dollar" arrangements whereby money managers use brokerage commissions to pay for brokerage and research services. See Trust Banking Circulars 17 (March 19, 1980) and 25 (June 19, 1986). The use of trust fund balances to obtain financial benefits does not constitute payment for brokerage or research services within the meaning of Section 28(e).

In the past, the staff has stated that under limited circumstances, the use by a national bank trust department of free automated order entry systems to place orders with funds offered by an investment company may be permissible if the availability of such systems is not dependent on the investment of trust assets in a particular fund or group of funds. See, OCC Letter to William M. Doran dated July 1, 1983 (unpublished) (Attachment A). In such an arrangement, however, a bank trust department must receive no financial benefits based on its investment of trust funds in a particular investment. Past positions on the permissibility of such automated order entry (including "sweep") services may not be relied on as legal support for the acceptance of such financial benefits.

In sum, if a bank receives incentives for placing trust assets in an investment fund offered by a particular provider, the bank must pass those incentives on to the accounts which have had their assets invested in the fund. In the alternative, the receipt of such financial incentives must be authorized by local law, court order, or the governing instrument. See 2A W.F. Fratcher, Scott on Trusts, § 170, Duty of Loyalty (4th ed. 1987). In the absence of those circumstances, the receipt of such financial incentives is prohibited under 12 C.F.R. § 9.12(a) and is contrary to a bank's fiduciary responsibilities.

REMEDIAL ACTION

National banks that engage, or have engaged, in conduct inconsistent with their fiduciary duties may be subject to significant liability for breaches of these duties. They may also be subject to appropriate enforcement actions by the OCC which may be publicized. National banks that receive, or have received, financial benefits contingent upon investment of trust assets in



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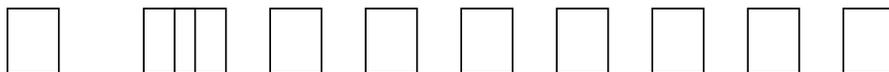
particular investment funds in violation of 12 C.F.R. § 9.12(a) and applicable fiduciary duties may be required to reimburse these benefits to the appropriate fiduciary accounts and to take other appropriate actions. In addition, appropriate referrals may be made to other interested federal and state government agencies, including the Securities and Exchange Commission, with respect to any investment companies or individuals aiding and abetting conduct by national banks that is inconsistent with the foregoing.

ORIGINATING OFFICE

Questions regarding this issuance may be directed to the Trust Activities Division at (202) 447-1731, or the Securities and Corporate Practices Division at (202) 447-1954.

Robert J. Herrmann
Senior Deputy Comptroller for
Bank Supervision Policy

Attachment



Attachment "A"

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

July 1, 1983

William M. Doran, Esq.
Morgan, Lewis & Bockius
1800 M Street, NW
Washington, DC 20035

Dear Mr. Doran:

This is in response to your letter dated April 6, 1983. In your letter, you requested an opinion concerning the permissibility of certain services offered to national bank trust departments by your client, SEI Corporation ("SEI") and its subsidiary, SEI Financial Services (SFS). Your letter contained a summary of the operation of your client's system.

Your letter noted that SEI generally is in the business of providing accounting, reporting, and management services to banks and other financial institutions. Included among these services are a general accounting, reporting and management service for bank trust departments. The trust system involves a standard level of computer software capability for which trust departments pay a service or license fee. The trust system provides certain accounting and administrative services, on-line portfolio information, and information relating to the processing of securities trades. Supplementary optional modules are available for additional fees.

According to your letter, SFS, a wholly-owned subsidiary of your client, is registered with the Securities Exchange Commission as a broker-dealer. SFS acts as the distributor and manager for several money market funds ("Funds") which are made available to customers of SEI and its subsidiaries. Purchase and sale orders may be communicated by telephone or automatically through software and terminals provided by SFS. As part of the latter arrangement, SFS provides trust departments with software which facilitates the placement of buy and sell orders to the funds after sweeping trust accounts to determine the cash balance available for investment (hereinafter referred to as "automated order entry system"). The trust department selects the particular Fund or portfolio within a Fund in which to invest trust assets by programming the automated order entry system. According to your letter, the features of the automated order entry system also include:

- (1) the daily detection of uninvested cash in each account and automatic daily investment of any or all of such balances;
- (2) the monthly crediting of money market fund dividends directly to each account;
- (3) a communication link to enable the bank fiduciary to execute special investment and redemption decisions when desired;
- (4) the display and printing of reports of each portfolio's composition, yield, tax characteristics, and other details upon the trustee's request so that the trust funds can be invested in the most appropriate portfolio of the subsidiary's money market funds.

Your letter also noted that SFS, as distributor of the Funds, provides the automated order entry system to maximize investment efficiencies and to eliminate errors that may occur in manual systems. Because the purpose of the automated order entry system is to facilitate investment in the Funds distributed by SFS, the trust departments are supplied with the system at no cost.

Your letter to this Office was prompted by my March 9, 1983, letter to the legal representative of another firm that designs and sells automated trust accounting systems, in which I expressed the view that an arrangement under which a national bank trust department receives a fee waiver on a general cash management system in exchange for investing funds in a particular money market fund was improper. Because the benefits of the fee waiver would not be passed onto the trust accounts, I concluded that the trust department would be receiving a benefit from the investment of trust assets in a certain vehicle; an arrangement which I believed violated the trust department's fiduciary duty of loyalty to the trust beneficiary. I also noted that the money market fund would presumably have to pay a lower return in order to compensate for the fee waivers on the sweep system.

Your letter of April 6 noted several points of distinction between the automated order entry system offered by SFS and the plan discussed in my letter of March 9. First, you indicated that use of the automated order entry system involves no fee waiver. The system is provided at no cost regardless of the levels of investment in the Funds by the trust department. Moreover, trust departments that use the automated order entry system and invest in the Funds do not receive any fee waiver or discount on other systems or products offered by SEI or its subsidiaries including the trust system and the cash management system. Second, you noted that the automated order entry system is an expense of SFS, the Fund manager, and not of the Funds themselves. Management fees paid the Fund manager by the Funds are a fixed percentage of daily fund assets and, in your view, are competitive with other money market funds. Third, your letter stated that the automated order entry system provides no general benefit to a trust department. The system is used to place orders only with SFS Funds. Fourth, you noted that even assuming, arguendo, that the cost of the automated order entry system is charged to the accounts that use the investment vehicle, you felt that this would be a more equitable allocation of the cost than to charge all accounts for a service that benefits only those accounts investing cash balances in the funds.

In your letter, you expressed the opinion that a national bank trust department could purchase shares in the Funds where an automated order entry system, which includes a sweeping feature, is provided by the Fund's distributor at no cost. In your view, such investment by a trust department is proper as long as the trust department decides that the investment is prudent under standard investment criteria. You believe that trust accounts are benefitted by the automated order entry system because cash is expeditiously invested and therefore yield is maximized. Moreover, you noted that the automated order entry system allows trust departments to monitor and reallocate account balances to the most appropriate portfolios offered by the Funds.

Additionally, your letter noted that a June 25, 1982 OCC release indicated that the sweep systems are an effective method by which trust departments can invest uninvested cash into income-producing media on a daily basis, that the cost of implementing such systems is not necessarily prohibitive, and that "certain money market funds can provide banks with a daily investment service for individual accounts." 47 Fed. Reg. 27830 (June 25, 1982) reprinted at [Current] Federal Bank Law Reporter (CCH) ¶ 99, 205. You noted that the Funds are examples of money market funds that provide such a daily investment service through the automated order entry system.

Initially, I would like to stress my agreement with the views expressed in the OCC release cited in your letter. Sweep systems are indeed an effective method for national bank trust departments to invest uninvested cash. However, the arrangement under which such a system is provided to a trust department must still comply with the exacting fiduciary standards imposed on a trustee.

The arrangement described in my March 9 letter, under which a fee waiver for a general cash management system was expressly conditioned upon investment of trust assets in a particular vehicle, represented, in my opinion, a clear example of a breach of the trust department's fiduciary duty of loyalty because it appeared that the trustee's decision to invest in the subject funds was motivated in large measure by the benefit conferred upon the trust department in the form of lessened operating costs. I responded accordingly and I reaffirm the opinion expressed in that letter. The arrangement described in your letter, however, has several features which distinguish it from the arrangement discussed in my March 9 letter. For example, your letter indicated that the automated order entry system is provided to the trust departments at no cost regardless of the amount of trust assets invested in the Funds. Moreover, your letter stated that the use of the system is limited to facilitating buy and sell orders in the Funds. Under these circumstances, I do not believe that a trust department's use of the automated order entry system to invest in the Funds would be improper per se, provided that the investment itself is otherwise appropriate.

I stress that the primary responsibility of a trust department is to ensure that the investments chosen for each account represent the most appropriate investments for that account, considering all the relevant facts and circumstances. If a trust department, after using its independent investment judgment, determines that one of the Funds represents the best investment available for certain accounts, I believe that an automated order entry system may be employed to make the investments. However, the trust department should keep appropriate records to demonstrate that it is exercising the required independent investment discretion on a continuing basis without

regard to the automated order entry system. The trust department must be prepared to justify all its investment decisions.

My opinion is based strictly on the operations of your client as described in your letter and repeated here. This letter expresses no opinion on the merits of any product, service or investment vehicle offered by any company.

Sincerely,

Peter Liebesman
Assistant Director
Legal Advisory Services Division

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