

**FEDERAL RESERVE BANK
OF NEW YORK**

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**RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS:
EXAMINATION PROCEDURES**

*To the Chief Executive Officers of all State Member Banks,
State Licensed U.S. Branches and Agencies of Foreign Banks,
and Bank Holding Companies in the Second Federal Reserve District:*

In recent years, banking organizations have become increasingly active in selling uninsured nondeposit investment products, such as mutual funds, to retail customers on bank premises. In response to this development, the four Federal financial institution regulators issued an Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement) on February 15, 1994, which was distributed to your organization shortly thereafter.

Printed on the following pages are the examination procedures developed by the Federal Reserve for use when examining retail sales of nondeposit investment products conducted on bank premises. The examination procedures are intended for use when examining State member banks and State licensed U.S. branches and agencies of foreign banks. They may also be used during inspections of bank holding companies and their nonbank subsidiaries that sell nondeposit investment products on the bank premises.

Should you or your staff have any questions regarding these examination procedures or the related Interagency Statement, please contact Elizabeth Irwin-McCaughey, Manager, Compliance Examinations Department (Tel. No. 212-720-6820).

CHESTER B. FELDBERG
Executive Vice President

Board of Governors of the Federal Reserve System

**EXAMINATION PROCEDURES FOR
RETAIL SALES OF
NONDEPOSIT INVESTMENT PRODUCTS**

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Comments regarding these procedures may be addressed to the attention of the Securities Regulation Section, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington D.C. 20551.

I. INTRODUCTION

In recent years, depository institutions have become increasingly involved in selling uninsured nondeposit investment products, such as mutual funds or annuities, to retail customers on their premises. In response to this development, four federal financial institution regulators issued an Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement) on February 15, 1994¹ in an effort to enhance customer protection and lessen possible customer confusion that such products are insured deposits. The Interagency Statement applies to all insured banks and thrifts, including state member banks and the U.S. branches and agencies of foreign banks.

The guidelines contained in the Interagency Statement² apply to retail recommendations or sales of nondeposit investment products made by:

- Employees of a banking organization;
- Employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises); and
- Sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

The following examination procedures are intended to determine if the bank's policies and procedures provide for an operating environment that is designed to ensure customer protections in all facets of the sales program. Furthermore, examiners are expected to assess the bank's ability to conduct such sales activities in a safe and sound manner.

These procedures apply when reviewing the nondeposit investment product retail sales activities conducted by state member banks or the state licensed U.S.

¹The Interagency Statement was issued to Federal Reserve Banks under cover of a supervisory letter, SR 94-11, dated February 17, 1994. This SR letter superseded SR 93-35 dated June 17, 1993, which addressed the retail sale of mutual funds on state member bank premises.

² These examination procedures and the Interagency Statement will be included in the Commercial Bank Examination Manual and the Bank Holding Company Supervision Manual.

branches or agencies of foreign banks. They also apply to such activities conducted by a bank holding company nonbank subsidiary on the premises of a bank.

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) govern sales of securities by its member broker dealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities³ and require that sales of registered securities be accompanied by a prospectus that complies with SEC disclosure requirements.

In view of the existence of these securities rules and laws which are applicable to broker dealers subject to supervision by the SEC and the NASD, examiners should note that the examination procedures contained herein have been tailored to avoid duplication of examination efforts by relying on the most recent examination results or sales practice review conducted by the NASD and provided to the third party. To the extent that no such NASD examinations or reviews have been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope before proceeding further. Notwithstanding our use of NASD results of sales practice reviews, examiners should still complete the balance of these examination procedures, particularly those pertaining to the separation of sales of nondeposit investment products from the deposit taking activities of the bank.

Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on bank premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the Interagency Statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should apply these examination procedures when retail customers are directed to the institution's trust department where they may purchase nondeposit investment products by simply completing a customer agreement.

For additional information on the subject of retail sales of nondeposit investment products, examiners and other interest parties may find it helpful to refer to "Retail Investment Sales - Guidelines for Banks", February 1994 (Industry Guidelines), published collectively by six bank trade associations and available from

³ See, for example, Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. 240.10b-5) thereunder.

the American Bankers Association, 1120 Connecticut Avenue, N.W., Washington D.C. 20036.

PROGRAM MANAGEMENT

Banking organizations must adopt policies and procedures governing nondeposit investment product retail sales programs. Such policies and procedures should be in place prior to the commencement of the retail sale of nondeposit investment products on bank premises.

The board of directors of a banking organization is responsible for ensuring that retail sales of nondeposit investment products comply with the Interagency Statement and all applicable state and federal laws and regulations. Therefore, the board, or a designated committee of the board, should adopt written policies that address the risks and management of such sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, address the institution's arrangements with any third parties selling such products on bank premises. The banking organization's policies and procedures should be reviewed periodically by the board of directors, or its designated committee, to ensure that they are consistent with the institution's current practices, applicable laws, regulations and guidelines.

As discussed in more detail below, an institution's policies and procedures for nondeposit investment products should, at a minimum, address disclosure and advertising, physical separation of investment sales from deposit taking activities, compliance and audit, suitability, and other sales practices and related risks associated with such activities. In addition, policies and procedures should address:

Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on a depository institution's premises. Institutions should periodically review products offered to ensure they meet their customers' needs.

Use of Identical or Similar Names

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the bank or its affiliates. However, a bank may sell a nondeposit investment product with a name

similar to the bank as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule, under Regulation Y (12 C.F.R. 225.125), when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment advisor to a mutual fund. In such a case, the fund may not have a name that is identical to, similar to, or a variation of, the name of the bank holding company or a subsidiary bank.

Permissible Use of Customer Information

Banking institutions should adopt policies and procedures regarding the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The Industry Guidelines permit institutions to share with third parties only limited customer information, such as name, address, telephone number, and types of products owned. It does not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments, net worth, etc., without the customer's prior acknowledgement and written consent.

Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under such arrangements, the third party has access to the institution's customers, while the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to sell such products directly. Third parties include wholly-owned subsidiaries of a bank, bank affiliated broker dealers (i.e., Section 20 companies or discount brokerage firms), unaffiliated broker dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

A banking institution should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. Such review should include an assessment of the third party's financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with the Interagency Statement.

The Interagency Statement calls for banking institutions to enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on bank premises. Such agreements should be

approved by an institution's board of directors, or its designated committee. Agreements should outline the duties and responsibilities of each party, describe third party activities permitted on institution premises, address the sharing or use of confidential customer information for investment sales activities, and define the terms for use of the institution's office space, equipment, and personnel. If an arrangement includes dual employees, the agreement must provide for written employment contracts that specify the duties of such employees and compensation arrangements.

In addition, a third party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the Interagency Statement. The agreement should authorize the institution to monitor the third party's compliance with its agreement, and authorize the institution and Federal Reserve examination staff to have access to third party records considered necessary to evaluate such compliance. These records should include examination results, sales practice reviews and related correspondence provided to the third party by securities regulatory authorities. Finally, an agreement should provide for indemnification of the institution by an unaffiliated third party for the conduct of its employees in connection with such sales activities.

Notwithstanding the provisions of a third party agreement, a banking institution should monitor the conduct of nondeposit investment product sales programs to ensure that sales of nondeposit investment products are distinct from other bank activities and are not conducted in a manner that could confuse customers regarding the lack of insurance coverage for such investments.

Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates, stock market valuations, etc. In the event of a sudden, sharp drop in the market value of nondeposit investment products, institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Therefore, management should develop contingency plans to address these situations. A major element of any contingency plan should be the provision of customer access to information pertaining to their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

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DISCLOSURES AND ADVERTISING

Content, Form and Timing of Disclosure

Nondeposit investment product sales programs should be conducted in a manner that ensures that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The Interagency Statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the FDIC;
- They are not deposits or other obligations of the institution and are not guaranteed by the institution; and
- They are subject to investment risks, including the possible loss of the principal invested.

Disclosure is the most important way of ensuring that the differences between nondeposit investment products and insured deposits are understood by retail customers. Accordingly, it is critical that the minimum disclosures be presented in a clear and concise manner in both oral and written communications. In this regard, the minimum disclosures should be provided:

- Orally during any sales presentations (including telemarketing contacts) or when investment advice is given;
- Orally and in writing prior to or at the time an investment account to purchase these products is opened; and
- In all advertisements and other promotional materials (discussed further below).

The minimum disclosures may be made on a customer account agreement or on a separate disclosure form. The disclosures must be conspicuous (i.e., highlighted through bolding, boxes, and/or larger typeface). Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banking organizations are to obtain a written acknowledgement – on the customer account agreement or on a separate form – from a customer confirming that the customer has received and understands the minimum disclosures. For nondeposit

investment product accounts established prior to the Interagency Statement, banking organizations should obtain a disclosure acknowledgement from the customer at the time of the customer's next purchase transaction. If an institution solicits customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgement to be signed and returned to the institution.

Customer account statements, including combined statements for linked accounts, and trade confirmations for that are provided by the bank or an affiliate, should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements which provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

Advertising

The Interagency Statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. When displaying promotional sales materials related to nondeposit investment products in the bank's retail areas, they should be grouped separately from material related to insured bank products.

Telemarketing scripts should be reviewed to determine whether bank personnel are making inquiries about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In such cases, the scripts must contain the minimum disclosures and bank personnel relying on such scripts must be formally authorized to sell nondeposit investment products by their employers. Further, these personnel must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see Training below).

Additional Disclosures

A depository institution should apprise customers of certain material relationships. For example, a customer should be informed by sales personnel orally and in writing prior to the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the institution. Similarly, fees, penalties, or surrender charges associated with a nondeposit investment product should be disclosed by sales personnel orally and in writing prior

to or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than FDIC (e.g., SIPC insurance of broker dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage also must be provided to customers at that time in order to minimize possible confusion with FDIC insurance. Such disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

SETTING AND CIRCUMSTANCES

Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on the premises of a banking institution may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, make investment recommendations about investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

Forming an opinion whether nondeposit investment product sales activities are sufficiently separate from deposit activities requires an evaluation of the particular circumstances of each bank. FDIC insurance signs and insured deposit related promotional material should be removed from the investment product sales area and replaced with appropriate signs indicating that the area is utilized for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

In the case of banks that are affiliated with Section 20 companies that sell retail investment products directly to bank customers, the requirement for separation of deposit taking facilities from the Section 20's securities operations is absolute under the relevant firewall conditions imposed on Section 20 companies by the Board. Accordingly, retail sales activities conducted by a Section 20 company must be in a separate office which, at a minimum, is set off from deposit taking activities by

partitions and identified by signs with the name of the Section 20 company. Further, Section 20 company employees may not be dual employees of the bank.

Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker dealer.

The Interagency Statement was intended generally to cover sales made to retail customers in the bank lobby. However, some institutions may have an arrangement whereby retail customers purchase nondeposit investment products at a location of the institution generally confined to institutional services (e.g., corporate money desk). In such cases, the banking institutions should still ensure that retail customers receive the minimum disclosures in order to minimize any possible confusion with nondeposit investment products and insured deposits by such customers.

Hybrid Instruments and Accounts

In those cases in which an institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash management account,⁴ the accounts should be opened at the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, and special care must be taken by the institution in the account opening process to ensure that a customer is accurately informed that:

- Funds deposited into a sweep account will only be FDIC insured until they are swept into a nondeposit investment product account; and
- Customer account statements may disclose balances for both insured and nondeposit product accounts.

DESIGNATION, TRAINING AND SUPERVISION OF SALES PERSONNEL AND PERSONNEL MAKING REFERRALS

Hiring and Training of Sales Personnel

Banking organizations hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. In cases in which candidates for employment have previous investment industry experience, the

⁴ A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements.

bank should check whether the individual has been the subject of any disciplinary actions by securities, state or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer protection issues. In addition, training programs should cover the institution's policies and procedures regarding sales of nondeposit investment products, and should be conducted on a continuing basis to assure that staff continues to be familiar with new products and compliance issues.

For those bank employees whose sales activities are limited to mutual funds or variable annuities, the equivalent training is that ordinarily needed to pass NASD's Series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's Series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, a banking organization should be satisfied that the third party is able to train third party and dual employees with respect to compliance with the minimum disclosures and other requirements of the Interagency Statement. Copies of third party training and compliance materials should be obtained and reviewed by the bank in order to monitor the third party's performance regarding its training obligations.

Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations or sell nondeposit investment products, but who may refer customers to authorized nondeposit investment products sales personnel, should receive training regarding the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, pre-qualify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. Such personnel may contact customers for the purposes of:

- Determining whether the customer wishes to receive investment information;

- Inquiring whether the customer wishes to discuss investments with an authorized sales representative; and
- Arranging appointments to meet with authorized bank sales personnel or third party broker dealer registered sales personnel.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not include the provision of investment advice, the identification of specific investment products or the making of investment recommendations.

Supervision of Personnel

Banking institution policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as referral activities by bank employees not authorized to sell these products. Personnel assigned responsibility for management of sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal as required by the NASD for broker dealers. Supervisory personnel should be responsible for the institution's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the Interagency Statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the Interagency Statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

SUITABILITY AND SALES PRACTICES

Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on an institution's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the banking institution is responsible for the preservation of the principal of their investment.

Banking institutions that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing suitability of

investment recommendations and related record keeping requirements. Sales personnel that recommend nondeposit investment products to customers should have reasonable grounds for believing that the products recommended are suitable for the particular customer on the basis of information provided by the customer. A reasonable effort must be made to obtain, record and update information concerning the customer's financial profile (e.g., tax status, other investments, income), investment objectives and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the banking institution's policies and procedures. The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded and updated (for subsequent purchases), and whether investment recommendations appear unsuitable in light of such information.

Nondeposit investment product sales programs conducted by third party broker dealers are subject to the NASD's suitability and other sales practice rules. To avoid duplicating NASD examination efforts in this regard, examiners should rely on the NASD's most recent sales practice review of the third party when available. To the extent that no such NASD review has been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

Sales Practices

The banking organization should have policies and procedures that address undesirable practices by sales personnel intended to generate additional commission income through the churning or switching of accounts from one product to another.

Customer Complaints

The banking organization should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable time frames should be established for addressing complaints.

COMPENSATION

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring

prospective customers to an authorized sales representative, and non-monetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (e.g., mutual fund distributors) to banking organization staff must be approved in writing by bank management; be consistent with the bank's written internal code of conduct relating to the acceptance of remuneration from third parties; and be consistent with the proscriptions of the Bank Bribery Act (18 U.S.C. 215) and the banking agencies' implementing guidelines to that act (see SR 87-36; dated October 30, 1987, or 52 Federal Register 39,277, October 21, 1987). Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way as to result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (e.g., proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the overall performance of the group in meeting bank objectives regarding a broad variety of bank services and products, and is not based principally on the volume of sales on nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of the fee should not depend on whether the referral results in a transaction. Non-monetary compensation to bank employees for referrals should be similarly structured.

Auditors and compliance personnel should not participate in incentive compensation programs directly related to the results of nondeposit investment product sales programs.

COMPLIANCE

Institutions must develop and maintain written policies and procedures that effectively monitor and assess compliance with the Interagency Statement and other applicable laws and regulations and assure appropriate follow-up to correct identified deficiencies. Compliance programs should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance findings should periodically be reported to the institution's board of directors or a designated committee of the board as part of their ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training

and experience with nondeposit investment product sales programs, applicable laws and regulations, and the Interagency Statement.

Banking organizations should institute compliance programs for nondeposit investment products that are similar to those of securities broker dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potential abusive practices such as unsuitable recommendations, churning or switching practices. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. MIS reports on early redemptions and sales patterns for specific sales representatives and products should also be used by compliance personnel to identify any potentially abusive practices. In addition, referral activities of bank personnel should be reviewed to assure that they are conducted in a manner that conforms to the guidelines in the Interagency Statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including conformance to the disclosure and separate facilities guidelines of the Interagency Statement. The results of such oversight should be reported to the board of directors or to a designated committee of the board. Management should obtain the third party's commitment promptly to correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

AUDIT

Audit personnel should be responsible for assessing the effectiveness of the institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit's review of nondeposit investment product activities will depend on the complexity and sales volume of a sales program, and whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the Interagency Statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Findings should be reported to the board of directors, or a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

II. EXAMINATION OBJECTIVES

RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

1. To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and nondeposit investment products and receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.

2. To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.

3. To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the Interagency Statement, Federal Reserve guidelines, regulations and applicable laws.

4. To assess the effectiveness of the institution's compliance and audit programs for nondeposit investment product operations.

5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or when the institution has failed to comply with the Interagency Statement or applicable laws and regulations.

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III. EXAMINATION PROCEDURES FOR RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

SCOPE

These procedures are based on the guidelines outlined in the Interagency Statement. The Interagency Statement applies to all banking organizations, including state member banks and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

These examination procedures are intended for use when examining a state member bank (or a state licensed U.S. branch or agency of a foreign bank) that engages directly in the retail sale of nondeposit investment products. They should be used in conjunction with examination procedures related to the recordkeeping and confirmation practices applicable to banks selling securities directly to customers that are contained in section 204.1 (questions 24-35) of the Commercial Bank Examination Manual.

This set of examination procedures is also meant to be utilized in conjunction with those contained in the Federal Reserve's Bank Holding Company Supervision Manual when examining a nonbank subsidiary that sells nondeposit investment products on bank premises. See the following sections for related examination procedures:

- Nonbank Subsidiaries Engaged in Underwriting and Dealing - Section 20 Subsidiaries, at section 2185.0;
- Section 4(c)(8) of the BHC Act - Investment or Financial Advisers, at section 3130.1;
- Section 4(c)(8) of the BHC Act - Securities Brokerage, at section 3230.0;
- Providing Administrative and Certain Other Services to Mutual Funds at section 3600.27

PROGRAM MANAGEMENT AND ORGANIZATION

1. Evaluate the institution's structure and reporting lines (legal and functional) for its retail nondeposit investment products operations. Determine whether retail sales of nondeposit investment products are being made directly by employees of the depository institution or through an affiliated or unaffiliated third party. Identify the principals responsible for the management of the nondeposit investment products sales program. Review their backgrounds, qualifications and tenure with the institution.
2. Determine the role of the board of directors of each legal entity involved in the sale of nondeposit investment products in authorizing and controlling nondeposit investment products activities on bank premises. Evaluate the adequacy of MIS reports relied upon by the board (or a designated committee) and senior management to manage these activities.
3. Describe the membership and responsibilities of management or board committees for nondeposit investment product retail sales programs. Review minutes maintained by these committees for information related to the conduct of retail nondeposit investment product sales programs.
4. Review and evaluate the institution's policies and procedures, objectives, and budget for nondeposit investment products activities. In so doing, consider the following:
 - a) Who prepared the material;
 - b) How it fits into the institution's overall strategic objectives;
 - c) Whether the goals and objectives are realistic;
 - d) Whether actual results routinely are compared to plans and budgets.
5. Determine how policies and procedures for nondeposit investment product activities are developed and at what level in the institution they are formally approved. Review the policies and procedures to see that they are consistent with the Interagency Statement and that they address the following matters:
 - a) Disclosure and advertising;
 - b) Physical separation from deposit taking activities;
 - c) Compliance programs and internal audit;
 - d) Hiring, training, supervision and compensation practices for sales staff and personnel making referrals;
 - e) Types of products offered, selection criteria;

- f) Restrictions on mutual fund use of names similar or identical to that of the bank holding company or its subsidiary banks;
 - g) Suitability and sales practices;
 - h) Use of customer information;
 - i) Transactions with affiliated parties; and
 - j) Role of third parties, if applicable.
6. Determine how management oversees compliance with these policies and procedures.
7. Review the product selection and development process to ensure that it considers customer needs and investment objectives.
8. Determine if the depository institution is covered by blanket bond insurance applicable to nondeposit investment product retail sales activities.
9. If the institution sells proprietary nondeposit investment products and performs related backoffice operations, review:
- a) The work flow and position responsibilities within the sales and operations function; and
 - b) Available flow charts, job descriptions, and policies and procedures.
- After discussions with management, conduct a walk-through tracing the path of a typical transaction. Evaluate the effectiveness and efficiency of the work flow and the overall operation.
10. Determine whether the institution has established any contingency plans for nondeposit investment product programs for handling adverse events, such as a sudden market downturn or period of heavy redemptions.
11. Review the institution's earnings and evaluate:
- a) Profitability of nondeposit investment products activities, including any investment advisory fees they may receive; and
 - b) Income and expense from the sales, investment advisory, and proprietary fund management activities related to nondeposit investment products, as a percentage of noninterest income and expense.

DISCLOSURES AND ADVERTISING

The Interagency Statement identified certain minimum disclosures that must be made to customers. They are that nondeposit investment products

- are not insured by the Federal Deposit Insurance Corporation (FDIC);
- are not deposits or other obligations of the institution and are not guaranteed by the institution; and
- are subject to investment risks, including the possible loss of the principal invested.

2. Determine whether the minimum disclosures are being provided orally to customers during sales presentations (including telemarketing contacts) or when providing investment advice on specific investment products.
3. Determine if the customer account agreement (or a separate disclosure form) presents the minimum disclosures in a clear and conspicuous manner. The disclosures should be prominent (e.g., highlighted through bolding, boxes, and/or larger typeface), and should be located on the front of the customer account agreement or adjacent to the customer signature block.
4. Determine whether customers sign an acknowledgement that they have received and understand the minimum disclosures. The acknowledgement can be on the customer account agreement or it can be on a separate disclosure form. Determine that customers who opened accounts prior to issuance of the Interagency Statement receive the written minimum disclosures and acknowledge receipt at the time of their next transaction. Review a sample of customer accounts to determine whether customers received the minimum oral and written disclosures.
5. In those cases in which sales confirmations or account statements provided by the bank or an affiliate bear the name or logo of the bank or an affiliate, determine that the minimum disclosures are conspicuously contained on the front of the documents.
6. Review advertisements and promotional material that identify specific nondeposit investment products to determine that they conspicuously contain the minimum disclosures. Any materials that contain information about insured deposits and nondeposit investment products should clearly segregate the information about investment products from the information about deposits.
7. Review telemarketing material used to solicit new business. To the extent that employees identify specific products, seek customer investment objectives,

make investment recommendations or give investment advice, determine whether:

- a) The minimum disclosures are included in the script;
 - b) Bank employees engaged in telemarketing activities are authorized by the bank to recommend or sell nondeposit investment products and whether their training is the substantive equivalent of that required for securities registered representatives; and
 - c) The material contains any statements that may be misleading or confusing to customers regarding the uninsured nature of nondeposit investment products.
18. In those cases in which nondeposit investment products are sold by employees of an affiliated broker dealer, determine that any written or oral representations concerning insurance coverage provided by SIPC, a state insurance fund, or a private insurance company, are clear and accurate and do not suggest that they are the substantive equivalent to FDIC insurance available for certain deposit products.
19. In cases in which the bank or its bank holding company (or affiliate) acts as an investment advisor to, or has some other material relationship with, a mutual fund whose shares are sold by the bank, determine that:
- a) oral and written disclosure of the relationship is made prior to the purchase of the shares;
 - b) bank advised mutual funds do not have names identical to the bank;
 - c) bank advised mutual funds with names similar to the bank are sold pursuant to a sales program designed to minimize the risk of customer confusion; and
 - d) bank holding company advised mutual funds do not have names identical to, similar to or a variation of the name of the holding company or its subsidiary bank.
20. Determine that disclosure of any sales charges, fees, penalties, or surrender charges relating to nondeposit investment products is made orally and in writing prior to the purchase of these products.

THIRD PARTY AGREEMENTS

21. In those cases in which sales of nondeposit investment products are conducted by employees or representatives of a third party, review all contractual

agreements between the bank and the third party to determine whether they cover the following:

- a) Duties and responsibilities of each party;
- b) Third party compliance with all applicable laws and regulations, and the Interagency Statement;
- c) Authorization for the institution to oversee and verify compliance by the third party;
- d) Provision for access to relevant records to the appropriate bank supervisory authorities;
- e) Written employment contracts for dual employees;
- f) Indemnification of the institution by the third party for the conduct of its employees in connection with nondeposit investment product sales activities; and
- g) Policies regarding the use of confidential customer information for any purpose in connection with sales of nondeposit investment products.

22. Obtain and review the most recent NASD examination results for the third party from the bank or the third party broker dealer. Also obtain and review examination related correspondence and any disciplinary matters between the broker dealer and the NASD or SEC. Review the institution's progress in addressing any investment recommendations or deficiencies noted in the examination results or other material.

23. Where any retail sales facilities of the institution are leased to an affiliated third party that sells nondeposit investment products:

- a) Assess whether the lease was negotiated on an arm's length basis and on terms comparable to similar lease agreements in the local market; and
- b) Review any intercompany relationships for compliance with Sections 23A and 23B of the Federal Reserve Act.

SETTING AND CIRCUMSTANCES

24. Determine whether the sale of nondeposit investment products is conducted in a physical location distinct from deposit taking activities of the bank. In so doing:

- a) Verify that nondeposit investment products are not sold from teller windows;

- b) Determine that signs or other means are used to distinguish the nondeposit investment products sales area from the retail deposit taking area of the institution;
- c) Determine whether space limitations preclude having a separate investment products sales area, and, if so, whether the institution clearly distinguishes nondeposit investment products from insured bank products or obligations; note how this is accomplished; and
- d) Determine if retail sales of nondeposit investment products are being conducted by a Section 20 company; if so, determine that such sales are conducted through a separate office (i.e., a location physically separate from the deposit taking area of the bank which, at a minimum, is set off by partitions and identified by signs with the name of the Section 20 company) and that no Section 20 company employee is a dual employee of the bank.

QUALIFICATIONS AND TRAINING

25. Determine whether employees of a depository institution are providing investment advice, making investment recommendations or selling nondeposit investment products directly to retail customers. If so, determine whether:
- a) Background checks have been performed by the depository institution; and
 - b) Sales personnel have received training that is the substantive equivalent to that provided to a securities registered representative.
26. Review the training program provided to employees of the depository institution that are authorized to provide investment advice, make investment recommendations or sell nondeposit investment products. Assess whether the program addresses the following subject matters:
- a) General overview of U.S. financial markets;
 - b) Detailed information concerning specific product lines being offered for sale;
 - c) Generally accepted trading practices for the products available for sale;
 - d) General overview of federal securities laws and regulations (antifraud and disclosure);
 - e) Banking regulations and guidelines applicable to sales activities (e.g., anti-tying prohibitions, Interagency Statement, supervisory letters on sales of specific investment products, etc.);
 - f) Policies and procedures specific to the institution;

- g) Appropriate sales practices, including suitability of investment recommendations and disclosure obligations; and
 - h) Appropriate use of customer lists and confidential customer information.
7. Determine whether the institution has any continuing education program or periodic seminars on new products or compliance.
 3. Determine whether supervisors of bank sales personnel receive special training pertaining to their supervisory responsibilities that is the substantive equivalent of training required for supervisors (General Securities Principals) of registered representatives.
 9. Review training of bank employees who are not authorized to sell nondeposit investment products but who make referrals, such as tellers, customer service representatives, and others. In so doing, determine whether such employees have been provided training in appropriate referral practices, including the limits on their activities.

SUITABILITY AND SALES PRACTICES

The following procedures on suitability and sales practices are applicable when conducting an examination of a depository institution whose employees offer investment advice, make investment recommendations, or sell nondeposit investment products. Examinations involving registered broker dealers should rely on the NASD's review of sales practices or its examination to assess the organization's compliance with suitability requirements.

0. Determine whether depository institution personnel recommend nondeposit investment products to customers. If so, determine that sales personnel obtain, record, and update the following information (* not necessary when money market mutual funds are being recommended):
 - a) Age;
 - b) Tax status;
 - c)* Current investments and overall financial profile, including an estimate of net worth;
 - d)* Investment objectives; and
 - e)* Other personal information deemed necessary to offer reasonable investment advice.
1. Review a representative sample of customer accounts that were opened at several different branch locations. Assess whether customer suitability

information is obtained, and whether investments appear unsuitable in light of such information.

- 32. Review customer complaints involving suitability of investment recommendations. Determine whether the bank's original recommendations appear unsuitable in the context of the information available at the time of sale. Note how suitability complaints are resolved.

COMPENSATION

- 33. If employees of the depository institution provide investment advice, make investment recommendations, or sell nondeposit investment products, determine:
 - a) Whether any incentive compensation plan available to nondeposit investment product sales personnel strongly favors proprietary or other specific products; and, if so, determine how the institution ensures that customers are not placed into unsuitable investments; and
 - b) Whether compliance and audit personnel are excluded from incentive compensation programs directly related to the results of nondeposit investment product sales.
- 34. Determine that fees paid to bank employees for referrals to depository institution sales personnel or third party sales staff are based on a one-time, nominal fee of a fixed-dollar amount and are not dependent on a successful sale.
- 35. Determine that the bank's compensation policies address remuneration of bank employees by third parties and that these policies are incorporated in the bank's code of conduct. In so doing, determine that the bank's policies were approved by the board of directors and are consistent with the proscriptions of the Bank Bribery Act and the interagency guidelines adopted thereunder.

COMPLIANCE AND AUDIT

- 36. Review and assess the depository institution's compliance program for nondeposit investment product sales activities. In so doing, consider the following:
 - a) Frequency and scope;
 - b) Workpapers;

- c) Degree of independence from the sales program;
 - d) Follow-up on material findings;
 - e) Centralization of findings from all compliance areas; and
 - f) Role of the board of directors in reviewing findings.
37. Review the criteria used to evaluate bank sales personnel for compliance with the institution's policies and procedures, specifically, those policies relating to disclosure and suitability.
38. Determine whether compliance personnel approve or review new accounts, periodically review transactions in accounts, and review sales and referral activities of bank personnel.
39. Review the customer complaint process and the associated complaint log to determine if complaints are addressed on a timely basis.
40. Review progress in addressing identified compliance problems.
41. Evaluate the experience, training and qualifications of compliance personnel.
42. Review the scope of audits and determine if the following areas were adequately addressed:
- a) Disclosure and advertising;
 - b) Physical separation of nondeposit investment product sales activities;
 - c) Compliance;
 - d) Sales practices and suitability;
 - e) Product selection and development;
 - f) Use of confidential customer information by bank and third party sales personnel;
 - g) Third party compliance with agreement with the institution;
 - h) Personnel training and background checks; and
 - i) Operations (clearing, cash receipts and disbursements, accounting, redemptions, etc.), if applicable;
43. Obtain all internal and external audit reports regarding the institution's nondeposit investment product activities performed over the past year (including management's responses). Review for exceptions, recommendations, and follow-up actions. Ascertain if significant exceptions were presented to the institution's audit committee or board of directors for their review.
44. For external audits, obtain a copy of the engagement letter and comment on the adequacy of the firm's audit review.