ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

Policy Number	95-2
Effective Date	11-01-95
Supersedes	
Approval	

SUBJECT: Retail Sales of NonDeposit Investment Products

INTRODUCTION

The sale of nondeposit investment products, which is defined for this policy to include equity securities, bonds, mutual funds, and annuities, by Arkansas state chartered banks, has increased over the last few years. To provide guidance for this type of activity, this examination policy has been issued in conjunction with the Interagency Statement issued February 15, 1994 by the four Federal banking regulatory agencies. A bank's compliance with these policies should be evaluated as a part of the examination process.

Although the Interagency Statement does not generally apply to sales of nondeposit investment products to nonretail customers, such as sales to fiduciary accounts administered by an institution, examiners should apply the recommended 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.

AUTHORITY TO SELL NONDEPOSIT INVESTMENT PRODUCTS

A Resolution addressing the sale of securities for bank customers and others was issued by the State Banking Board as of March 8, 1983.

All Arkansas banks were authorized to sell fixed or variable annuities through Act 592 of 1995 which amended A.C.A. Section 23-64-203. This act allowed all banks to be licensed to sell credit life insurance as well as fixed or variable rate annuities.

Individuals that sell nondeposit investment products must be registered with the National Association of Securities Dealers (NASD) and the Arkansas Securities Department. The chart below lists the required examination series an individual must pass before he/she is qualified to sell a particular type of security or nondeposit investment product in Arkansas:

PRODUCT	REQUIREMENTS TO SELL
Mutual Funds	Series 6 or 7, AND Series 63
Fixed Rate Annuities	Fixed annuity license issued by Arkansas Insurance Department
Variable Rate Annuities	Series 6 or 7, AND Series 63

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PRODUCT	**REQUIREMENTS TO SELL**
Equity Securities	Series 7 or 62, AND Series 63
Government Securities	Series 52 or 7, AND Series 63
Municipal Securities	Series 52 or 7, AND Series 63

MARKETING OF NONDEPOSIT INVESTMENT PRODUCTS

This examination policy applies to nondeposit investment products marketed through three different methods. The first marketing method is directly through the bank's employees. The second marketing method utilizes employees of a third party, which may or may not be affiliated with the bank and which sell the nondeposit investment products on the bank's premises (including sales or recommendations initiated by telephone or by mail from the bank premises). The third method involves sales of nondeposit investment products resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

A majority of all nondeposit investment products are sold by agents of third parties. The bank is able to offer nondeposit investment products to its customers without committing a large part of its personnel to the selling of these products or the time consuming servicing of customer accounts. Third parties include bona fide subsidiaries[1] of the bank, bank affiliated broker/dealers of the bank's holding company, or unaffiliated broker/dealers. Other entities such as insurance companies may be used by banks to sell annuities and other nondeposit investment products.

RISKS ASSOCIATED WITH THE SALE OF NONDEPOSIT INVESTMENT PRODUCTS

With the possible reward of higher fee income comes the added risks associated with the marketing of any product. Three main risks are of supervisory concern. These include litigation risks, compliance risks, and performance risks. All three risks should be assessed by management and the examiner to determine if the risk of selling nondeposit investment products outweighs the rewards of the offered service.

[1] Compliance with 12 CFR 337.4 is required for state nonmember banks conducting securities activities through affiliates or subsidiaries.

Litigation risks are usually created when a bank does not properly disclose to its customers that its nondeposit investment products:

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

Other litigation risks can be caused by unethical sales techniques such as churning or switching of accounts. The National Association of Securities Dealers (NASD) Rules of Fair Practice expressly governs the sales of securities by broker/dealers and their agents.

Compliance risks are created by noncompliance with all applicable laws of the Securities and Exchange Commission (SEC), NASD, the Arkansas Securities Department, the Arkansas Insurance Department, and the bank's state and federal regulators. Noncompliance with these agencies could result in enforcement actions, fines, and suspension of the sale of nondeposit investment products by the bank. Banks choosing to sell nondeposit investment products must have a compliance monitoring system to ensure compliance with all applicable laws.

Performance risks are created when customers become dissatisfied with the performance of their investments. These unhappy customers may withdraw deposits they had with the bank and establish banking relationships with competing institutions. Other performance risks arise when the expense associated with the sale of nondeposit investment products exceeds the income the products generate. Additionally, the sale of non-deposit investment products exposes the bank to additional embezzlement schemes and improprieties. Auditing procedures of a bank choosing to sell nondeposit investment products must be able to identify these additional risks.

EXAMINATION PROCEDURES FOR BANKS SELLING NONDEPOSIT INVESTMENT PRODUCTS

1. Determine the bank's marketing method of Nondeposit Investment Products. For affiliated organizations selling nondeposit investment products, check the **Officer's Questionnaire**. The Arkansas State Bank Department is granted authority to examine affiliates of any state chartered bank through A.C.A. Section 23-32-1104. Direct inquiries to management may be needed if the bank uses its own employees or a subsidiary, uses an unaffiliated vendor on its premises, or refers its customers to a third party vendor and receives a referral fee. Refer

to Retail Sale of Nondeposit Investment Products Examination Procedures Work Papers for additional information.

2. Check with the Department to determine that the broker/dealer firm the subject bank is using has not had "past disciplinary actions" issued by the NASD or the Arkansas Securities Department. The NASD/Arkansas Securities Department has regulatory/examination authority for all broker/dealers and their agents operating in Arkansas. The NASD has agreed to cooperate with the four federal banking agencies in the supervision of banks which sell nondeposit investment products.

3. Complete the Retail Sale of Nondeposit Investment Products Examination Procedures Work Papers. Keep in examination workpapers for future reference.

4. Assess the following factors to be included in the Management comment of the Report of Examination: technical competence regarding nondeposit investment products; compliance with all governing regulations; compliance with internal policies; compliance with the Federal Regulators' Interagency Statement; and contingency risks associated with the sale of nondeposit investment products.

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ARKANSAS STATE BANK DEPARTMENT
RETAIL SALE OF NONDEPOSIT INVESTMENT PRODUCTS
EXAMINATION PROCEDURES--WORK PAPERS

Bank Name: ______________ Charter number: ____________________

Date: ______________________ Examiner Assigned: ____________________

State chartered banks are permitted to engage in sales of nondeposit investment products, provided the Board of Directors has ensured the bank has adequate expertise on hand, and appropriate policies and procedures in place to conduct these activities in a safe and sound manner. If management permits the sale of nondeposit investment products without addressing the aforementioned issues, the bank may be subjected to substantial risks including potential liability to provide restitution to improperly advised customers and possible loss of customer confidence through association with high-risk products.

If the examination procedure does not apply, mark as N.A.

REGISTRATION REQUIREMENTS

Review extent and nature of activity to determine whether the nondeposit Investment activity is conducted through a subsidiary of the bank, an affiliate of the bank, or an unaffiliated third party. Under Arkansas Law, banks are directly exempt from registration requirements as broker/dealers with the Arkansas Securities Department. Accordingly, if the bank has chosen to directly sell nondeposit investment products, it can do so through a wholly owned subsidiary, or an affiliate company owned by the bank's holding company. Any employees of a wholly-owned bank subsidiary or affiliate organization selling nondeposit investment products <u>must</u> be registered with the NASD and the Arkansas Securities Department. Most state chartered banks provide nondeposit investment products services by referring customers to unaffiliated third parties; therefore, no registration is needed for the bank's employees making the referrals.Examiners should refer irregular noncomplying, or questionable activity to the EIC, who will coordinate inquiries with the Bank Department, and/or Arkansas Securities Department.

If the activity is conducted through a third party provider selling at the bank's offices, determine whether the third party provider is registered with the Arkansas Securities Department.

List the in state officer or partner acting as supervisor of the broker/dealer firm which conducts the customers' nondeposit investment trades. Name/Title__________

If the activity is conducted by an employee of the bank's subsidiary or an affiliate of the bank, verify the employee's registration with the Arkansas Securities Department.

If nondeposit investment products are sold in any of the bank's branches, check for proper licensing of the agents selling the products.

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DISCLOSURE AND SUITABILITY

Determine whether adequate verbal and written disclosures are made regarding the risk of the product.

Review all marketing material, including sample oral sales dialogues, brochures, lobby displays, and advertising (newspaper, radio, television) copy to determine that the following are conspicuously disclosed:

_______ Not insured by the FDIC.
_______ Not an obligation of the bank.
_______ Not guaranteed by the bank.
_______ Investment risk, including the possible loss of principal.

Determine whether sales information adequately discloses the associated costs:

Is the product subject to any early withdrawal penalties, surrender charge penalties, or deferred sales charges?

is the effect of commissions and fees on yields disclosed in a complete an understandable manner?

Determine whether the product is adequately distinguished from bank products.

If the bank as joint advertising with the nondeposit investment products seller, does the advertising clearly segregate information?

Do account statements sent to nondeposit investment purchasers reference the bank in any way?

Do nondeposit products have names that are different and not easily confused with deposit products?

Determine whether sales activity is adequately segregated from deposit-taking and other banking functions:

If the product is sold by a bank employee, determine whether the employee moves to a separate location within he bank to make the transaction.

determine that no uninsured products are sold from the same desk, window, or lobby area where insured deposits are transacted. If the bank's premises are limited, determine that **extra** emphasis is made in disclosing the products uninsured status.

Determine the employees who accept retail deposits (tellers) are prohibited from giving investment advice and from selling retail nondeposit investment products.

Determine whether bank employees with customer contact have signed an acknowledgment limiting their sales activity to bank products, if applicable.

Determine that any dual employee (if applicable) adequately disclose that they work for both the bank and the broker/dealer.

Determine whether the bank provides any information on its customers (i.e. maturing CDs) to third party or dual broker/dealers, without the prior written consent of the customer.

Review the prospectus of products offered for sale to determine whether any apparently high-risk products are offered. For example, long-term bond funds or funds composed of nonrated investments generally carry higher risk than short-term Government or rated municipal funds.

Review the variety and diversity of products offered. Does the bank offer enough products to provide a range for differing customer needs?

If annuities are offered, determine that the bank is registered with the Arkansas Insurance Department and that personnel conducting the sales are registered insurance agents.

Determine whether adequate procedures are employed to determine the suitability of a product for a customer prior to its sale:

Do sales representatives make a reasonable inquiry into a customer's financial condition or other investments?

Is inquiry made regarding the customer's comfort level for risk to their investment principal?

Is inquiry made concerning the customer's investment objective, i.e., growth, income, tax deferral?

Review a sample of customer files to determine.

Is there adequate documentation to indicate that the customer understands that the nondeposit investment is not insured and that the nondeposit investment is not a bank product?

Do customers sign a disclosure document when the nondeposit account is opened?

Is appropriate documentation maintained to reflect that the salesperson had reasonable grounds to believe a recommended investment was suitable for the customer at the time of the transaction? Is this determination based on information obtained directly from the customer?

Are the files updated periodically?

MANAGEMENT AND OVERSIGHT ACTIVITY

Evaluate the adequacy of Board-approved written policies and procedures. These should address, at a minimum:

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Supervision of personnel involved in nondeposit investment products

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The roles of other entities selling on bank premises.

The types of products the bank will sell.

The manner in which customers will be informed regarding the uninsured status of investment products.

The permissible uses of bank customer information; and

How compliance will be monitored.

Review the Board's evaluation of the products being offered in terms of risk, suitability, etc. Ensure that evaluations are performed on a periodic basis.

Review management reports regularly going to the Board to determine whether they are adequate to supervise the activity.

If the bank is affiliated with a third-party broker/dealer, determine whether the Board undertook a complete evaluation of the third party before entering into an agreement by:

Determining the third party's ability to fulfill commitments evidenced by capital strength and operating results disclosed in current financial data, annual reported, credit report, etc.;

Inquiring into the entity's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the entity;

Questioning appropriate State and Federal securities industry self-regulatory organizations (i.e. National Association of Securities Dealers), as to formal enforcement actions against the dealer or its affiliates or associated personnel;

Inquiring, as appropriate, into the licensing status and background of sales representative(s) to determine experience and expertise; and

Conducting periodic reviews of the entity once a relationship has been established.

If the activity is conducted through a third-party broker/dealer, review the written agreement between the bank and the provider to ensure that it:

Requires compliance with all applicable registration and regulatory requirements;

Indicates that bank management and regulators will be verifying compliance to applicable laws and regulation;

Provides examiner access to records of broker's activities at the bank;

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Details terms for compensation for bank space, equipment, and personnel used by the third-party; and

Indemnifies the bank for any claims arising out of the securities brokerage service.

Determine that background inquiries have been performed on sales personnel who are bank employees with previous security industry experience. The inquiry should check for any possible disciplinary history with securities regulators.

Review the resumes and visit the sales personnel employed by the bank to determine whether they are qualified and adequately trained to sell all nondeposit investment products offered by the bank.

Do they have a thorough product knowledge and understand customer protection requirements?

Have they received adequate and ongoing training?

Review the level and nature of compensation provided the employee/sales personnel for reasonability and propriety. Compensation should not operate on an incentive basis for salespersons if a more appropriate option is available. If tellers participate in a referral program, banks should not base compensation on success of sale.

Review the adequacy of audit procedures and policy in the area:

Determine whether written audit procedures and policy are established for nondeposit investment products.

Have audit and compliance personnel been properly trained and qualified?

Does the compliance function include a system to monitor customer complaints and periodically review customer accounts to prevent abusive practices?

Does compliance personnel review progress in addressing identified compliance problems?
Are compliance findings periodically reported to the bank's board of directors?

determine whether the bank has received a written acknowledgment from its blanket bond carrier regarding direct or indirect sale of nondeposit investment products.

EXAMINATION REPORT

If the bank is not involved in any way in retail sales of nondeposit investment products, state as much in the confidential section of the report.

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If the bank is involved in any way in retail sales of nondeposit investment products, discuss activity in the Management Comment. significant activity or weaknesses should also be discussed in Overall Examination Conclusions. Comments should address the following at a minimum:

Nature of activity, registration
Where it is conducted
Who is involved
Whether products have any particular risk characteristics
Disclosure adequacy
Documentation of suitability
_ Quality of management and board oversight.

REFERENCES

The following sources of information may be used for further guidance:

Interagency Statement on retail Sales of Nondeposit Investment Products, 2-15-94

12 CFR 337.4 "securities Activities of Subsidiaries of Insured Nonmember Banks: Bank transactions with Affiliated Securities Companies"

OCC Bulletin 94-13 "Examination Procedures for Retail Nondeposit Investment sales", 2-24-94

Board of Governors of the Federal Reserve System "Examination Procedures for Retail Sales Of Nondeposit Investment Products", 5-31-94

FDIC Transmittal 94-067 "Examination Procedures for Banks Involved with the Sale of Nondeposit Investment Products", 4-28-94

DOB Numbered Memo 88-06 "Unsuitable Investment Practices", 5-20-88

Chapter 42 of the Arkansas Code of 1987 Annotated